Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-332

F. EBERSTADT & CO., INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC. and ROBERT G. ZELLER,

Petitioners,

—against—

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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—against—

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners seek a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit entered June 17, 1977.

Opinions Below

The opinion of the Court of Appeals (A-5)* is reported at 552 F.2d 402. The opinion of the District Court (A-75) is reported at 399 F.Supp. 945.

* References preceded by "A" are to the appendix to this petition. References preceded by "JA" are to the joint appendix in the Court of Appeals.

Jurisdiction

This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1). The entry of the Court of Appeals' judgment on June 17, 1977 followed the Court's denial on June 6, 1977 of a petition for rehearing and a suggestion that the appeal be reheard *en banc*.

Questions Presented

1. Do the Securities and Exchange Commission proxy rules, promulgated pursuant to the Securities Exchange Act of 1934, require the disclosure of business alternatives which were properly rejected by a corporation's board of directors in the good faith exercise of independent business judgment?

2. Was it error for the Court of Appeals to usurp the function of the District Court by reversing its judgment on an issue which had been abandoned in the District Court and not tried, so that petitioners had no opportunity to present evidence with respect to that issue?

Statutes Involved

Since the proxy statements here involved were those of Chemical Fund, Inc., an investment company or mutual fund registered with the SEC under the Investment Company Act of 1940, 15 U.S.C. §§ 80, *et seq.*, the fund proxy statements were governed by section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), 54 Stat. 822 and SEC Rule 20a-1, 17 Code Fed. Reg. § 270.20a-1. However, Rule 20(a)-1 makes applicable to investment companies the SEC proxy rules issued under section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), 78

Stat. 569. The relevant proxy rule under section 14(a) of the Exchange Act is Rule 14a-9(a), 17 Code Fed. Reg. § 240.14a-9(a). All of these statutes and rules are reproduced in the appendix to this petition.

Statement of the Case

This is a shareholder's derivative action brought under the Investment Company Act of 1940, 15 U.S.C. §§ 80 *et seq.*, on behalf of Chemical Fund, Inc. against petitioner F. Eberstadt & Co., Managers and Distributors, Inc. ("M&D"), the Fund's investment adviser; petitioner F. Eberstadt & Co., Inc., a member firm of the New York Stock Exchange which owns the controlling stock interest in M&D, and petitioner Robert G. Zeller, a fund director who is also an officer of both M&D and Eberstadt.

Plaintiff contended in the District Court that petitioners were obligated as a matter of law to reduce the management fee paid by the Fund to M&D by pursuing the "recapture" of brokerage commissions paid by the Fund on transactions in its portfolio securities. Until recently, it was possible for the Fund to recapture commissions by having Eberstadt execute its portfolio transactions on the New York Stock Exchange; until 1968, recapture was also possible by directing executing brokers on the Exchange to "give-up" a portion of their commissions to Eberstadt. Plaintiff's theory was that M&D could have reduced its management fees to the Fund in the amount of some or all of the profits derived from Eberstadt's participation in the Fund's brokerage business.

The Chemical Fund's non-management directors, whom the District Court found to be independent and not in any sense controlled or dominated by Eberstadt or M&D (A-76), had determined that notwithstanding the possibility of

reducing the Fund's management fee by the recapture of brokerage commissions, Eberstadt should not participate in any way in the Fund's brokerage business. The directors were concerned, among other things, with avoiding even the appearance of conflicts of interest.

The only issue tried in the District Court was whether the Investment Company Act made recapture mandatory. Petitioners contended in the District Court that recapture was a matter of business judgment for determination by the Fund directors; respondent argued that as a matter of fiduciary obligation, recapture was required by the Investment Company Act.

The District Court dismissed the case after trial on the basis of its findings that the board of directors of the Fund, consisting of independent "men of repute in academia, business and the professions" (A-76) made in good faith a reasonable and fully informed business judgment that the Fund should not seek recapture. That holding was affirmed by the Court of Appeals.

Nevertheless, the Court of Appeals reversed the District Court on a theory which was neither tried nor properly raised in the District Court. The Court of Appeals held that the proxy statements of the Fund for the years 1967 through 1971 were false and misleading for failing to disclose the possibility of recapture which an independent board of directors had properly rejected in the independent exercise of business judgment as not in the best interests of the Fund.* The Court of Appeals remanded the case to the District Court for determination of what damages,

* The SEC participated as *amicus curiae* in the Court of Appeals at the invitation of the Court and urged affirmance of the District Court's dismissal of the complaint. The SEC *amicus* brief did not address the disclosure issue on which the Court of Appeals reversed.

if any, should be assessed against petitioners by reason of the falsity of the Fund's proxy statements.

The Court of Appeals reversed on an issue which had been abandoned in the District Court and had never been tried.

The complaint did not attack the Fund's proxy statements or allege any failure of disclosure (JA 2). While a "second cause of action" alleged that the management fees paid by the Fund were excessive and that the management contracts were invalid (JA 10), that claim was abandoned in the pre-trial order (JA 27, ¶ 1; JA 38, ¶ 3(b); JA 43, ¶ 7).

The enumeration of plaintiff's contentions and claims for relief in the pre-trial order (JA 38, 48) made no mention of proxy statements or of any failure to make adequate disclosure.

In his opening statement at the trial, plaintiff's counsel said:

> ". . . The issue here is really a single issue, the failure of the Fund to recapture a portion of the commissions on portfolio transactions, . . ." (JA Tr. 6).

The only question put to any witness at the trial which was expressly directed to Fund proxy statements was a single question asked of a Fund director by plaintiff's counsel on cross-examination (JA Tr. 196-7):

> "Was it ever clear in the prospectus, in the proxy statements or in any other communication to the shareholders of the fund that give-ups were being directed prior to December 5, 1968, to brokers who did not participate in the execution?"

The answer was "no".

Plaintiff did not attack Fund proxy statements in the District Court until it was too late to do so—in her post-trial proposed findings of fact. But even then, the only defect alleged was the failure to disclose that the Fund's brokerage practices were breaches of contract and of the Fund's certificate of incorporation and that brokers who received give-ups did not participate in the execution of portfolio transactions (¶ 43). Plaintiff also attacked on other grounds the 1972 proxy statement, but the Court of Appeals held that the 1972 proxy statement was adequate.

There can be no doubt, as petitioners pointed out in their brief in the Court of Appeals, that plaintiff's argument with respect to the Fund proxy statements was not properly raised in the District Court (p. 48). Accordingly, the issue could not be properly raised on appeal.

Reasons for Granting the Writ

I.

The Court of Appeals' Erroneous Interpretation of the Proxy Rules Would Undermine the Materiality Standards Established by This Court.

The Court of Appeals' decision that the Fund's proxy materials were false and misleading is so aberrational that no precedent is or can be cited to support it. Never before, so far as we know, has a federal court held that a corporation is required to detail in proxy statements business alternatives which an independent board of directors has properly rejected as not in the best interests of the corporation.

The error and exceptional importance of the decision cannot be deemed limited by the Court's observation that in the mutual fund industry, "self dealing . . . is the order of the day" (A-10). Boards of directors in every line of

business are frequently compelled to make business decisions which involve conflicts of interest; if the Court of Appeals is correct, the existence of a conflict of interest involving corporate management would require the disclosure of rejected business alternatives even if the rejection was made, as it was in this case, by disinterested directors who acted reasonably and properly.

The decision by the Court of Appeals that the Fund's proxy statements were materially false and misleading is inconsistent with and would undermine the standard for materiality established in *TSC Industries* v. *Northway, Inc.*, 426 U.S. 438 (1976). There, this Court held that an omitted fact is material only if it "would have assumed actual significance in the deliberations of the reasonable shareholder." (*Id.* at 449). Under this test, no corporation should be required to describe in its proxy materials those business alternatives which an independent board of directors has properly rejected as not in the interests of the corporation.

Chemical Fund's proxy statements for the years in question did inform shareholders of the Fund's practices with respect to brokerage (A-63). The Court of Appeals held, however, that detail of possible alternative business practices was required for the shareholders to make a reasoned judgment as to the performance of the Fund's managers. By ruling as it did, the Court of Appeals will inevitably stimulate cautious management to inundate shareholders with descriptions of the minutiae of decisionmaking, thus frustrating this Court's effort to ensure disclosure of meaningful, relevant, and easily assimilated information (*Id.* at 448-49).

It is inconceivable that a description of esoteric brokerage alternatives is so obviously material that reasonable men could not differ about its significance. The finding of *per se* materiality, therefore, constitutes a substantial de-

parture from the *TSC Industries* test. If not overruled, the Court of Appeals judgment will establish a precedent for *sub silentio* evasion of that standard by judicial determinations that materiality is "obvious" as a matter of law (A-72-73).

For the mutual fund industry, the decision below spells disaster. The Court said that the Fund's false and misleading proxy statements over a five-year period "rendered ineffectual the shareholders' approval of the management agreements" between the Fund and its investment adviser (A-72). In two of those years, 1970 and 1971, the Fund shareholders approved new management contracts pursuant to which the adviser received compensation of approximately $3.9 million (A-82).

Even though the District Court found that this rate of compensation was less than the industry average and that the investment adviser rendered superior services (A-82, 93-94), plaintiff can be expected to argue on remand that M&D should be required to disgorge some or all of the clearly reasonable compensation it received for superior services rendered.

As the opinion below makes clear, the availability of recapture was not unique to Chemical Fund. Most of the larger mutual funds in the industry have rejected recapture, except for those few which distribute their shares through captive sales forces rather than through independent securities dealers and hence have no occasion to allocate brokerage business to dealers who sell fund shares (A-23-24) and except for those which adopted recapture techniques in order to settle shareholder litigation.* Almost without ex-

* *See, e.g., Weiss* v. *Chalker*, 59 F.R.D. 533, 535 (S.D.N.Y. 1973); *White* v. *Auerbach*, CCH Fed. Sec. L. Rep. ¶ 93,617, at p. 92,827 (S.D.N.Y. 1972); *Schulsselberg* v. *Keystone Custodian Funds Inc.*, CCH Fed. Sec. L. Rep. ¶ 93,901 (S.D.N.Y. 1973).

ception, none of these funds disclosed in its proxy materials that recapture was available but had been rejected.

If the decision below stands, most mutual fund proxy statements in recent years will be deemed false and misleading, most mutual fund management contracts are in limbo and mutual fund managers and directors stand exposed to liability for failure to make proxy statement disclosure which no one, including the SEC, has ever considered necessary or appropriate.

In view of the Court of Appeals' observation that mutual funds are "fraught" with conflicts of interest (A-58), the decision would require that almost every important business decision made by a fund's board of directors be followed by proxy statement disclosure of rejected alternatives. Since any business decision necessarily embodies the rejection of alternatives, the panel's decision would require the very avalanche of trivia which this Court said in *TSC Industries* would defeat the purpose of the proxy rules (*Id.* at 448).

It is not in the public interest to put into limbo the management contracts under which mutual funds have operated for many years, to expose fund managers and directors to such liabilities that their ability to continue to serve is brought into question and to stimulate a new wave of derivative mutual fund litigation attacking fund proxy statements and management contracts for the past six years.

What the Court of Appeals has done is to promulgate retroactively a radical change in disclosure standards which the SEC, the expert body charged by Congress with the pronouncement of disclosure standards, *rejected* in 1972. In 1969 the Commission exposed for public comment guidelines reflecting the tentative view of the Commission staff with

respect to disclosure in mutual fund prospectuses (Investment Company Act Release No. 5634, Securities Act Release No. 4953, March 11, 1969). That release solicited "the views and suggestions of all interested persons before the guidelines are published in definitive form". The proposed guidelines would have required the following prospectus disclosure by mutual funds, like Chemical Fund, which decided not to pursue available recapture techniques:

> "The Company's board of directors and its adviser could agree to make an arrangement with & Company to return to the Company benefits equal to the brokerage commissions & Company receives on portfolio transactions from which the investment adviser benefits. No such arrangement has been made."

This, of course, was the very disclosure which the Court of Appeals held was necessary here.

More than three years later, having received "a considerable number of helpful comments" on the proposed guidelines, the Commission published definitive guidelines which rejected the disclosure proposed in 1969 for funds which had declined to pursue recapture. (Investment Company Act Release No. 7220, Securities Act Release No. 5259, June 9, 1972). The only disclosure requirement laid down with respect to recapture in the definitive guidelines is a description of recapture arrangements *if such arrangements had been made.* In that event, the suggested disclosure is:

> "[The Company and & Company have made an arrangement whereby % of the net profit from brokerage commissions earned on Company transactions placed with & Company is returned to the Company by (describe the mechanism through which the Company benefits, *e.g.* a reduction in the advisory fee.]"

The Commission thus rejected the very disclosure which the Court of Appeals mandated here.

We urge that the Court of Appeals erred when without advertent consideration of policy implications, impact upon an important industry in which millions of people have invested their savings or the views of the agency charged by Congress with administering the Investment Company Act and pronouncing disclosure standards, it laid down a burdensome and oppressive standard which would serve no useful purpose and which is inconsistent with the standard laid down by this Court in *TSC Industries.*

II.

In Reversing on an Issue Which Had Been Abandoned and Never Tried in the District Court, the Court of Appeals Erroneously Usurped the Function of the District Court.

As this Court said only recently in *Dayton Board of Education* v. *Brinkman,* U.S. , No. 76-539, June 27, 1977 (Slip Op., p. 3):

> "The proper observance of the division of functions between the federal trial courts and the federal appellate courts is important in every case."

Here, as in that case, the Court of Appeals failed to observe "the proper allocation of functions between the district courts and the courts of appeals within the federal judicial system". (*Ibid.*) And here, too, "the importance of the judicial administrative aspects of the case are heightened by the presence of the substantive issues on which it turns" (*Ibid.*)—an aberrational interpretation of the proxy rules which, until set aside, will undermine the materiality standards laid down by this Court in *TSC Industries.*

What the Court of Appeals did in this case was to hold that business alternatives properly rejected by an independent board of directors in the exercise of well-informed business judgment were "obviously" material as a matter of law, even though the issue of materiality was not properly raised or tried in the District Court. The Court of Appeals erred even if it could be correctly concluded on this trial record that disclosure of rejected business alternatives was an issue which should be tested by trial. In that event, the whole issue of materiality should have been remanded for trial rather than merely the issue of damages, if any.

On such a remand, petitioners would prove the following:

1. The availability of recapture was known to the SEC and its staff throughout the years in question.

2. Preliminary drafts of Fund proxy statements were filed with the SEC for staff review as required by SEC Proxy Rule 14a-6, 17 Code of Fed. Reg. § 240.14a-6. While the Commission staff on occasion required that additional disclosures be made, no one ever suggested that the availability of recapture be disclosed.

3. Most mutual funds, like Chemical Fund, rejected recapture as not in their best interests. Almost without exception, no fund which rejected recapture has ever disclosed the reasons for that decision or that recapture was available. We submit that adherence to industry disclosure practice, particularly since that practice was known to and not questioned by the SEC, is at least some evidence that disclosure was adequate.

4. The proxy statements in question were reviewed and approved before distribution to shareholders by the very directors whom the panel acknowledged to be independent and competent.

5. While ordinarily it is impossible to prove that shareholders would not have voted differently even if the disputed disclosure had been made, that is not the case here. Here, a management contract was submitted to Fund shareholders in 1970, 1971, 1972 and 1973. Defendants would prove on remand that in 1970 and 1971, years for which the Court below held the proxy statements to be defective, the shareholder votes approving the contracts were 95.96% and 94.3%, respectively, of those voting. On the other hand, in 1972 and 1973, years for which the Court of Appeals held that the availability of recapture was *adequately disclosed*, the shareholders approved the contracts by even wider margins. The shareholder vote approving the contract in 1972 was 98.18%; in 1973, it was 98.03%.

Orderly judicial procedure requires that this and other evidence regarding the proxy statements be evaluated in the first instance by the District Court.

CONCLUSION

The decision of the Court of Appeals is egregiously erroneous. The question it decided is of great importance in the administration of the federal securities laws. To burden proxy statements with the detail of rejected business alternatives would require the very avalanche of trivia which this Court said in *TSC Industries* would defeat the purpose of the proxy rules.

Respectfully submitted,

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August 30, 1977

APPENDIX "A"

Section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a):

(a) It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * * *

Section 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a):

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

* * * * *

SEC Rule 20a-1, 17 Code Fed. Reg. § 270.20a-1:

(a) No person shall solicit or permit the use of his name to solicit any proxy consent or authorization in respect of any security of which a registered investment company is the issuer, except upon compliance with §§ 270.20a-2 and

270.20a-3 and all rules and regulations adopted pursuant to section 14(a) of the Securities Exchange Act of 1934 that would be applicable to such solicitation if it were made in respect of a security registered on a national securities exchange. Unless the solicitation is made in respect of a security registered on a national securities exchange, none of the soliciting material need be filed with such exchange.

(b) If the solicitation is made by or on behalf of the management of the investment company, then the investment adviser or any prospective investment adviser and any affiliated person thereof as to whom information is required in the solicitation shall upon request of the investment company promptly transmit to the investment company all information necessary to enable the management of such company to comply with the rules and regulations applicable to such solicitation. If the solicitation is made by any person other than the management of the investment company, on behalf of and with the consent of the investment adviser or prospective investment adviser, then the investment adviser or prospective investment adviser and any affiliated person thereof as to whom information is required in the solicitation shall upon request of the person making the solicitation promptly transmit to such person all information necessary to enable such person to comply with the rules and regulations applicable to the solicitation.

(c) In lieu of the fees specified in Rule 14a-6 of the general rules and regulations under the Securities Exchange Act of 1934, at the time of filing the preliminary solicitation material, the person upon whose behalf the solicitation is made shall pay to the Commission a fee of $125, no part of which shall be refunded.

* * * * *.

SEC Rule 14a-9, 17 Code Fed. Reg. § 240.14a-9(a):

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

APPENDIX B

UNITED STATES COURT OF APPEALS

For the Second Circuit

No. 576—September Term, 1975.

(Argued February 9, 1976 Finally submitted May 20, 1976; Decided March 4, 1977.)

Docket No. 75-7503

Susan Tannenbaum,

Plaintiff-Appellant,

v.

Robert G. Zeller, F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Chemical Fund, Inc.,

Defendants-Appellees.

Before:

Lumbard and Timbers, *Circuit Judges,*
and Bryan, *District Judge.**

Appeal from a judgment of the United States District Court for the Southern District of New York, Robert L. Carter, *J.*, dismissing the complaint in an action by a shareholder suing on behalf of a mutual fund against the fund's investment adviser and others, alleging unlawful failure to recapture portfolio brokerage commissions for

* Frederick vP. Bryan, of the Southern District of New York, sitting by designation.

the benefit of the fund and the issuance of false and misleading proxy statements.

Affirmed in part and reversed and remanded in part.

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HARVEY L. PITT, General Counsel, PAUL GONSON, Associate General Counsel, JACOB H. STILLMAN, Assistant General Counsel, EDWARD A. SCALLET, Attorney, SEC, Washington, D.C., *for Securities and Exchange Commission, Amicus Curiae.***

BRYAN, *District Judge:*

The plaintiff in this derivative action is a shareholder of Chemical Fund Inc., a mutual fund (the Fund). She sued on behalf of the Fund against the Fund's investment adviser, F. Eberstadt & Co., Managers and Distributors,

** The amicus brief of the Securities and Exchange Commission (SEC) was filed at the request of the court on May 7, 1976.

Inc., its parent company, F. Eberstadt & Co., Inc., and Robert G. Zeller, a principal of the Fund, its investment adviser, and the parent company, for alleged unlawful failure to recapture portfolio brokerage commissions for the benefit of the Fund and for alleged inadequate disclosure of the Fund's brokerage practices to Fund shareholders.

After trial without a jury before Judge Robert L. Carter in the Southern District of New York on the question of liability only, judgment was entered dismissing the complaint. Judge Carter's opinion below is reported at 399 F. Supp. 945 (S.D.N.Y. 1975). Plaintiff appeals from that judgment.

The appeal presents troublesome questions concerning the duties of investment advisers and directors of mutual funds with respect to recapture of portfolio brokerage commissions for the benefit of the fund. The applicable legal principles were largely laid down by this court in Judge Friendly's comprehensive opinion in *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 45 U.S.L.W. 3250 (U.S. Oct. 4, 1976), which approved with some qualifications the holdings of the First Circuit in *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971), the only previous court of appeals decision dealing with the recapture problem. A basic question here is whether application of the *Fogel* and *Moses* principles to the facts in the case at bar requires reversal of the dismissal of the complaint by the court below.

The essential questions which we find presented and our rulings thereon are as follows:

(A) Did the manager and interested Fund directors have a duty to recapture excess commissions for the benefit of the Fund either under the Fund's charter or under the various agreements between the Fund and the adviser?

We hold they did not.

(B) Did the manager and interested directors violate their duty of disclosure to the independent directors under *Moses* and *Fogel*?

We hold they did not.

(C) Did failure to recapture violate section 36 of the Investment Company Act of 1940?

We hold it did not.

(D) Did the proxy statements for the years 1967-1971 violate the disclosure provisions of the federal securities laws?

We hold they did and remand for determination of what damages, if any, were caused by such violations.

I.

At the outset, a review of the background of the recapture problem in the mutual fund industry is in order. Since Judge Friendly's opinion in *Fogel,* and the authorities there cited,[1] cover this subject in considerable detail, the discussion here will be limited to what is essential for an understanding of the problems presented in this case.

The mutual fund industry is in many ways unique, which in part explains the specific federal regulatory legislation concerning it. *See, e.g.*, Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*; Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, *et seq.* A mutual fund is a "mere shell," a pool of assets consisting mostly of portfolio securities that belongs to the individual investors holding shares in the fund. The management of this asset pool is largely in the

1 *See also* Deutsch, FOGEL v. CHESTNUTT: *The Meaning of an Opinion*, 4 Sec. Reg. L. J. 375 (1977).

hands of an investment adviser, an independent entity which generally organizes the fund and provides it with investment advice, management services, and office space and staff. The adviser either selects or recommends the fund's investments and rate of portfolio turnover, and operates or supervises most of the other phases of the fund's business. The adviser's compensation for these services is a fee which is usually calculated as a percentage of the fund's net assets, and thus fluctuates with the value of the fund's portfolio. Portfolio transactions are carried out by brokers selected by the adviser, who receive commissions at the regular rates therefor. The sale of fund shares to new investors is generally the responsibility of a "principal underwriter" who is usually the adviser itself or a close affiliate. Actual sales are made by brokers or dealers selected by the underwriter, and the sales charge or "load" is divided between the selling broker or dealer and the underwriter.[2]

This management structure contrasts sharply with that of a typical corporation. In the usual corporate situation, the interests of management and shareholders are identical on most matters. Since the officers who run the corporation are paid directly by the corporation and usually have a substantial equity investment in it, they devote themselves to profit maximization and thus act in the best interests of both the corporation and themselves. Control of a mutual fund, however, lies largely in the hands of the investment adviser, an external business entity whose primary interest is undeniably the maximization of its own profits.

2 "Sales load" is defined in section 2(a)(35) of the Investment Company Act, 15 U.S.C. §80a-2(a)(35) as

> the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer. . . .

While the management and shareholders of a mutual fund have certain parallel interests (such as improving the quality of investment performance by increasing the value of the fund's portfolio and thus raising both the value of fund shares and the investment adviser's fee), there are important areas in which their interests may conflict. These include the level of management fees and sales charges, and various aspects of portfolio transactions. Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds,* 115 U. Pa. L. Rev. 1058, 1059-60 (1967). The situation caused by this unique mutual fund structure was serious enough to prompt the observation by the First Circuit that "self-dealing is not the exception but, so far as management is concerned, the order of the day." *Moses* v. *Burgin, supra,* at 376. *See Galfand* v. *Chestnutt Corp.*, Nos. 76-7156, 76-7170 (2d Cir., decided Nov. 4, 1976), slip op. at 410.

Congress sought to minimize the possibilities of abuse of position by mutual fund managers by means of the Investment Company Act of 1940, 15 U.S.C. §80a-1, *et seq.* This statute expanded the disclosure provisions already applicable to the industry under the Securities Act of 1933, 15 U.S.C. §77a, *et seq.*, and the Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq.*, and imposed specific requirements as to the structure and operation of mutual funds. *See* Comment, *Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment?* 1972 Duke L.J. 429, 433-35. Thus what was then section 10 of the Investment Company Act of 1940, 54 Stat. 806, required that at least 40 percent of a mutual fund's board of directors not be officers or employees of the investment company or "affiliated" with its investment adviser. This key provision was designed to place the unaffiliated directors in the role of "independent watchdogs" who would assure

that, in accordance with the preamble of the Investment Company Act, mutual funds would operate in the interest of all classes of their securities holders, rather than for the benefit of investment advisers, directors, or other special groups. The Act also placed specific restrictions on inside transactions, 15 U.S.C. §80a-17, and required that the contracts governing the relationship between a fund and its investment adviser be approved by investors and reexamined periodically, 15 U.S.C. §80a-15(a).[3]

While the 1940 Acts succeeded in correcting a number of obvious abuses which had been prevalent in the mutual fund industry prior to their enactment, it became apparent in the early 1960's that problems still remained. Believing that the existing regulatory scheme then relying on "unaffiliated" directors to police the industry had proved inadequate, the SEC set in motion a series of developments which raised for the first time the question of the recapture of portfolio brokerage commissions for the benefit of the fund, and eventually culminated in the Securities Act Amendments of 1975.

In *Fogel,* Judge Friendly summarized the origins of the recapture controversy:

> At the root of the recapture problem was the historic practice of the New York Stock Exchange (NYSE) and other exchanges of charging a fixed rate of commission on each share traded regardless of the size of the transaction (except for the odd-lot differential). Since the costs of executing an order do not vary in

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3 In 1970, section 2(a)(19), 15 U.S.C. §80a-2(a)(19), was added to the Act defining the term "interested person" to include those having close family or substantial financial or professional relationships with investment companies, their investment advisers, principal underwriters, officers, and employees. This concept was substituted for the "non-affiliated" requirements for fund directors under section 10 of the Act so as to require that the board be composed of at least 40 percent "non-interested" persons.

accordance with size, the large sales and purchases at the command of investment advisers of mutual funds were particularly attractive orders. At first fund managers allocated their brokerage business to reward brokers who had been helpful in selling the fund's shares, in furnishing advice, or in doing both: orders allocated as rewards were known as "reciprocals." However, as the business grew, the practice of reciprocals resulted, especially for the large funds, in using too many brokers, some of whom were not the best qualified to execute the particular order placed with them. Hence, there developed the practice of relying on a few executing brokers who were then instructed to "give-up" a portion of their commissions, sometimes as much as 75%, to another broker whom the fund manager wished to reward. On NYSE this was permitted only in favor of another member, but six of the seven regional exchanges permitted "give-ups" in favor of non-members as well, provided they were members of the National Association of Securities Dealers, Inc. (NASD).

533 F.2d at 735 (footnote omitted).

The proper use of the "excess" portion of brokerage commissions—that over and above what a broker would charge for his execution services were it not for the exchanges' fixed rates of commission—soon became a central question. Judge Friendly notes SEC awareness of the issue as early as 1963 when it issued its Report of the Special Study of Securities Markets, H.R. Doc. No. 95 Pt. 4, 88th Cong., 1st Sess. (1963). The SEC there concluded:

> 1. The pattern of reciprocal business in the mutual fund industry is unique. The economies of the volume of securities transactions generated by the mass purchasing power of the funds for the most part are of minor benefit to the funds themselves. The primary beneficiaries are their investment advisers and their frequently related principal underwriters who to a large extent use reciprocity to reward the sales efforts of fund retailers, thereby increasing their own rewards. The use by fund advisers of investment advice and research provided by brokerage firms in return for fund brokerage, without diminution of their investment advisory fees, is another indication of the manner in which they are the primary beneficiaries of reciprocal business. This unbalanced reciprocal structure is a direct outgrowth of a minimum commission rate structure which prohibits volume discounts and rebates. In the broad study of the commission rate structure recommended to the Commission in chapter VI-I, appropriate consideration should be given to the desirability and appropriate form of a volume discount from the viewpoint of mutual funds.

Id. at 234, quoted in *Fogel, supra,* at 735-36.

The SEC's first explicit pronouncement on the subject of recapturing excess brokerage commissions came in late 1966, in its Report on the Public Policy Implications of Investment Company Growth (PPI), H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966). The commission detailed the give-up and reciprocal practices which were being used to reward brokers furnishing sales and research services to mutual funds. It then described the mechanisms that some mutual funds had developed for recapturing excess commissions for the funds' direct cash benefit—which relied upon exchange rules permitting the reduction of the adviser's fee by some portion of brokerage commissions it received as give-ups or for actual execution—and concluded

that this course of action probably conferred greater benefits on the fund shareholders than alternative use of excess commissions. The SEC also observed, however, that until such time as these recapture procedures became widespread in the industry, any adviser-underwriter to a dealer-distributed fund who utilized them would find certain dealers disinclined to promote sales of its fund's shares since they could more profitably promote those of its competitors which did not recapture commissions.[4]

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4 This important passage of PPI, quoted in full in *Fogel, supra,* at 736, is reproduced here for the sake of both clarity and convenience:

(a) *Use of brokerage commissions to benefit the funds*

(i) *Reducing advisory fees.*—As has been noted, subsidiaries of four adviser-underwriters that maintain their own retail sales forces—among them three of the largest, Investors Diversified Services, Inc., Waddell & Reed, Inc., and Channing Financial Corp., as well as the smaller Imperial Financial Services, Inc.—are now members of the Pacific Coast Stock Exchange. These subsidiaries execute orders for the funds on the Pacific Coast Stock Exchange. More important, however, they obtain a considerable amount of nonfund business from broker-dealers who are dual members of the Pacific Coast Stock Exchange and other exchanges in return for fund brokerage business on other exchanges, primarily the NYSE. All the net profits of IDS's subsidiary and about 40 to 50 percent of the net profits of Waddell & Reed's and of Imperial Financial Services' subsidiaries have been applied to reduce advisory fees payable by the funds in those complexes.

Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions. However among dealer-distributed funds the important role that portfolio brokerage plays in the competition for dealer favor has kept fund managers, with few exceptions, from using exchange memberships to reduce costs of the funds.

Similar competitive factors have also operated against the use, for the benefit of the funds and their shareholders, of regional exchange rules permitting give-ups to any member of the NASD on transactions executed on those exchanges. It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds. Unless and until such procedures become widespread, any adviser-underwriter to a dealer-distributed fund who chose to utilize fund brokerage in this manner would place itself at a disadvantage in competing for the interest of nonmember dealers in selling the fund shares which it distributes. PPI at 172-73 (footnotes omitted).

At the same time that it viewed with approval the efforts of some futual funds to turn reciprocal and give-up practices to the direct cash advantage of shareholders, the Commission stated a broader view that

> certain aspects of these practices, particularly the customer-directed give-up, impair the orderly and proper functioning of the securities markets themselves.

PPI at 185. Accordingly, the SEC gave notice that "it believes that exchange rules must be changed so as to preclude customer-directed give-ups." PPI at 186.

The next development came when SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968) proposed a rule 10b-10 which, if it had been adopted, would have required a fund manager to recapture brokerage commissions whenever it was capable of so doing.[5] The release reasoned that mutual fund managers were under a fiduciary duty to utilize available recapture techniques. It also called for comment on a NYSE proposal to introduce a volume discount in brokerage commissions and make several changes in NYSE rules to limit give-ups and eliminate other reciprocal practices because of the distortions they caused in the market. The SEC viewed the NYSE proposal as essentially an alternative to its own proposed Rule 10b-10. *Fogel* v. *Chestnutt, supra,* at 739-40.

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5 This is the SEC's interpretation of the proposed rule. Such an affirmative duty to recapture, however, does not emerge so clearly from its text. *See Fogel* v. *Chestnutt, supra,* at 739.

Later in 1968 the SEC finally accepted NYSE proposals for a volume discount on orders exceeding 1,000 shares and other alterations in rates, and withdrew its proposed rule 10b-10. NYSE abolished customer-directed give-ups effective December 5, 1968, as did the regional exchanges shortly thereafter.

In 1969, the Commission continued to address the question of the duty of funds to recapture. In SEC Securities Exchange Act Release No. 8746 (Nov. 10, 1969), quoted in *Fogel, supra,* at 741, the General Counsel for the SEC, Philip A. Loomis, Jr., stated:

> You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interests of the fund to create such an affiliate. Proposed Rule 10b-10, as published for comment on January 26, 1968, to which you refer, has been withdrawn.

The release went on to note the Commission's understanding that the exchange rules abolishing give-ups did not prohibit the existing arrangements which a few mutual funds had made for the recapture of a portion of their commissions. It also cautioned that if a mutual fund management did acquire a seat on a regional exchange whose rules permitted the recapture of commissions through the use of that seat, there might be circumstances under which recapture would be required and management would not be free to retain revenues derived from that source for itself.

The next significant event occurred in 1972 when the SEC issued a Policy Statement on the Future Structure of the Securities Markets (Feb. 2, 1972). The *Fogel* opinion, *supra,* at 741-43, sets forth the pertinent passages in detail, and little would be gained by repeating them here. Suffice it to say that the Commission advocated the discontinuance of the use of portfolio brokerage to promote the sale of mutual fund shares, and the elimination of institutional memberships on the exchanges insofar as they were employed primarily as vehicles for obtaining recapture of commissions.

In response to this policy statement, the National Association of Securities Dealers proposed a rule abolishing the use of reciprocals to reward sales promotion by making sale of fund shares neither a qualifying nor disqualifying factor in the allocation of portfolio transactions. This rule became effective on July 15, 1973. The reaction to the other thrust of the policy statement, however, was quite different:

> By contrast, the validity of the SEC's conclusions on the evil of institutional memberships, which were quite at variance with the earlier pronouncements we have quoted, was vigorously challenged, notably by Elkins Wetherill, president of the PBW Stock Exchange, see Wetherill and Hendon, Institutional Membership and the Experience of the Philadelphia-Baltimore-Washington Stock Exchange, 13 Boston College Ind. & Com. Rev. 959 (1972). Senator Williams introduced a bill, S. 3169, 92d Cong. 2d Sess. (1972), which would remove the SEC's power to restrict institutional membership until one year after the effectiveness of a rule requiring negotiated rates on all transactions exceeding $100,000. Nevertheless, the SEC promulgated Rule 19b-2, effective March 29, 1973, forcing every exchange to "require every member of such exchange to have

as the principal purpose of its membership the conduct of public business."

Fogel v. *Chestnutt, supra,* at 743 (footnote omitted).

The final development was the Securities Act Amendments of 1975, which generally forbade exchange transactions for one's own account or that of an associate, as well as the imposition of fixed rates of commission by national securities exchanges—the cause of the whole problem. *See Fogel* v. *Chestnutt, supra,* at 734-44.[6]

Thus, the problem of recapture of mutual fund portfolio brokerage commissions became intertwined with and to a considerable extent absorbed by the broader problem of general policy with respect to the effect of brokerage commission allocations on the securities markets. In this connection, the stance of the SEC on the recapture question has considerable significance.

The Commission's position cannot be fairly characterized as consistent. The amicus brief filed by the SEC on this appeal at the request of the court frankly admits this and attributed the "possibly conflicting views" of the Commission on the recapture question to its dual responsibilities under the Investment Company Act and the Securities Exchange Act. A portion of that brief is instructive:

> Under the [Investment Company Act], the Commission focused primarily on the effect of the allocation of brokerage commissions on mutual funds, their advisers and their shareholders. At the same time, however, the Commission was more broadly concerned under the Securities Exchange Act with the effect of brokerage allocation on the securities markets. From the latter perspective, the Commission was concerned

6 The SEC rescinded rule 19b-2 in response to congressional reports accompanying these amendments.

> with such matters as the appropriateness of fixed commission rates, the effect of such commissions on the structure of the securities markets, and the role of the Commission as an economic regulator.
>
> As the Commission's thinking developed on these broader policy issues, and market characteristics continued to change and evolve, the Commission revised its prior positions to accommodate its market concerns. Undoubtedly, some persons regarded the Commission's later conduct as inconsistent with its prior positions on the narrower issues arising under the Investment Company Act.

The Commission's brief traces this "duality of approach" throughout all its discussion on recapture, and notes the agency's final determination to treat the practice as a problem of commission rates and market structure, rather than as a mutual fund problem. It concedes that

> it is difficult to find guidance—in the context of this lawsuit, involving a specific fact situation raising questions of the fiduciary obligation of investment advisers —in many of the Commission's general statements on the recapture problem.

The SEC points out, however, that the history of its response to the recapture problem is not unimportant since "it illustrates the dynamic and constantly changing background in which the defendants' actions in this case must be judged."

With the foregoing background in mind, we turn to the specifics of the case before us.

II.

Chemical Fund, Inc., a Delaware corporation, is an open-end, diversified investment company or mutual fund reg-

istered with the SEC under the Investment Company Act of 1940. Its investment objective is to attain growth of capital and income through investment in companies specializing in certain aspects of the sciences. As an "open-end" investment company, the Fund is required under sections 5(a)(1) and 2(a)(32) of the Investment Company Act, 15 U.S.C. §§ 80a-5(a)(1), -2(a)(32), to stand ready at all times to redeem its shares for their "net asset value", computed in accordance with the rules and regulations of the SEC, 17 C.F.R. §§ 270.22c-1, .2a-4. As of December 31, 1965, the Fund had total net assets of $433,849,751. At the time of trial, the Fund's total net assets were more than $700,000,000.

The Fund's investment adviser or manager and the distributor of its shares is, and has been for many years, F. Eberstadt & Co., Managers & Distributors, Inc. (M&D), a Delaware corporation. Pursuant to a written advisory contract, M&D makes investment advisory recommendations to the Fund's board of directors, and, subject to the approval of the board, manages the business and affairs of the Fund. It also furnishes the Fund with office space and ordinary clerical and bookkeeping services. As is customary in the industry, the compensation paid by the Fund to M&D for its services as the Fund's manager is based upon a percentage of the Fund's net assets, with an incentive adjustment for the Fund's investment performance.[7] At all relevant times M&D has been a member of the NASD.

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7 The management fees for the years 1965 through 1969 were

Year	Amount
1965	$1,160,563
1966	1,268,590
1967	1,428,228
1968	1,505,231
1969	1,521,868

Pursuant to a written distribution contract with the Fund, M&D arranges for the sale of Fund shares to the public through independent securities dealers at a price equal to net asset value plus a sales charge or commission. Under the terms of the distribution agreement, M&D retains less than a quarter of the sales charge and allows the balance to dealers who sell Fund shares.[8]

The parties have stipulated that at all times since at least January 1, 1965, when plaintiff's allegations commence, a majority of the Fund's board of directors have been neither "affiliated" nor "interested" persons within the meaning of the Investment Company Act. These unaffiliated or disinterested Fund directors were characterized by Judge Carter as men of repute in business and the professions.[9]

On March 20, 1970, and March 14, 1971, respectively, the schedule of fees to be paid to M&D was revised. The management fees for each of the years 1970 through 1973 were:

Year	Amount
1970	$1,662,203
1971	2,247,468
1972	3,097,640
1973	3,631,470

8 For the years 1965 through 1973, the Fund paid gross commissions to M&D (on the sale of the Fund's shares as distinguished from portfolio transactions) and M&D re-allowed to non-affiliated dealers, the amounts indicated below:

Year	Approx. Comm. Paid M&D	Approx. Comm. Re-Allowed
1965	$ 1,678,000	$1,443,000
1966	2,126,000	1,677,000
1967	1,599,000	1,237,000
1968	1,441,000	1,118,000
1969	1,328,000	1,034,000
1970	2,099,000	1,620,000
1971	3,166,000	2,434,000
1972	6,335,000	4,885,000
1973	10,751,000	8,251,000

9 This view was substantiated by his summary of their backgrounds:

Dr. James S. Coles, director since 1968, currently President of Research Corporation, a foundation for the advancement of science,

The defendant F. Eberstadt & Co. Inc. (Eberstadt), M&D's parent company, originally a partnership but later a Delaware corporation, is and has been since 1962 a member firm of the NYSE and a member of the NASD. Eberstadt later became a member of the American Stock Exchange as well.

Robert G. Zeller, the only individual defendant served, is vice-chairman of the Fund's board of directors, vice-chairman of M&D's board, and chairman of the board and chief executive officer of Eberstadt.

Except in unusual circumstances, whenever the Fund wishes to purchase or sell securities for its portfolio it is necessary for M&D to select a broker to execute the transaction or to deal directly with a dealer who owns or wishes to purchase the particular securities being purchased or sold. Total brokerage commissions paid in connection with such portfolio transactions on the NYSE (on which 80% of the transactions were executed), the American Stock

and before that President of Bowdoin College; Burt N. Dorsett, director since 1966, currently Vice President and Senior Investment Officer for College Retirement Equities Fund, and former Vice President for Investments at the University of Rochester; Alfred E. Driscoll, director since 1957, currently Chairman of the New Jersey Turnpike Authority and former governor of New Jersey; Dr. Bertrand Fox, director since 1970, recently retired Professor of Investment Banking at Harvard University Graduate School of Business Administration; Dr. Roger F. Murray, director since 1959, Professor of Banking and Finance at the Columbia University Graduate School of Business, formerly Vice President, responsible for portfolio management at Bankers Trust Co., and at one time manager of the investment portfolio of the Teachers Insurance and Annuity Association & College Retirement Equities Fund; Whitman Hobbs, director since 1972, John N. Martin, Franz Schneider, long time director, and Julian Avery, director until 1968, holding responsible positions in various corporate business institutions; Dr. Howard Rusk, director since 1962, well-known authority on rehabilitation and other medical questions; Leroy Marek, director from 1959-1973, a consultant on scientific problems and issues; and James J. Minot, director from 1968-1970, senior partner in Paine, Webber, Jackson & Curtis, Inc.

Exchange, and regional exchanges ranged from $339,860 in 1965 to $1,291,735 in 1973.

The parties have stipulated that, in selecting brokers for the execution of portfolio transactions, M&D's primary concern has always been securing the best price and quality of execution available to the Fund, i.e., the best execution.[10] Only when two or more executing brokers could provide equal price and quality of execution were other criteria considered in the selection of brokers.

Until July 15, 1973, the criteria employed in selecting a broker were the broker's sales of Fund shares to the public and the usefulness of research and statistical services which it provided to the Fund through M&D. After July 15, 1973, as previously indicated, an NASD rule, binding on both M&D and Eberstadt as members, eliminated sales of Fund shares as a qualifying or disqualifying factor in the selection of executing brokers.

The brokerage commissions paid by the Fund when the sale of shares was a criterion for selecting an executing broker fluctuated from $271,910 in 1965 to $462,613 in 1970. The commissions paid by the Fund when research and statistical services provided were criteria for selecting an executing broker fluctuated from $40,977 in 1965 to $91,662 in 1970. During 1971 and 1972 over 98% of the Fund's portfolio brokerage in each year was allocated as "reciprocals" to brokers who either sold Fund shares or supplied statistical and research information.

As we have seen, prior to December 5, 1968, it was common practice for a mutual fund or its manager to direct executing brokers on the NYSE and other national securities exchanges to "give-up" part of their commissions to

10 It was also stipulated that during the period in question no commission paid by the Fund exceeded the minimum commission prescribed by the constitution and rules of the exchange on which the particular transaction was executed.

other exchange members who had sold shares to the public or who had provided useful research or statistical material, but who had not participated in any way in the execution of the transaction on the exchange. The give-ups on Fund portfolio transactions from 1965 to 1968 exceeded the following amounts:

Year	*Amount*
1965	$ 81,686
1966	136,200
1967	214,600
1968	246,600

The NYSE permitted member firms who served as investment advisers to credit against the investment advisory fee some portion of the commissions earned by the member firm for the execution of portfolio transactions on behalf of the investment advisory client. Accordingly, the NYSE would have permitted M&D to credit against the management fee payable to it by the Fund some portion of any brokerage commissions earned by its present Eberstadt in the execution of the Fund's portfolio transactions and, prior to the time when give-ups were abolished, a portion of any give-ups received by Eberstadt with respect to Fund brokerage business. Prior to December 5, 1968 such recapture would not have required participation by Eberstadt in the execution of portfolio transactions. After December 5, 1968, when give-ups were abolished, recapture was still available although then, appellant asserts, participation by either Eberstadt or M&D in portfolio transactions would have been necessary.[11]

11 The parties stipulated in this case that, during the period of time covered by the complaint, several techniques whereby excess brokerage commissions could be recaptured for the benefit of the Fund were available. At trial, basically three separate available techniques were discussed, all of which depended to some extent on rules of the New York, American, and regional stock exchanges which permitted the crediting of some portion of brokerage commissions on portfolio transactions received by an investment adviser against its management fee. First, prior to December 5, 1968 when give-ups were permissible, the Fund could have directed the brokers who executed portfolio transactions for it on the New York Stock Exchange to give up part of the commission to Eberstadt, a member firm of the NYSE, to be applied against the M&D advisory fee. Second, even after the abolition of give-ups, the Fund could have placed its portfolio transactions directly with Eberstadt for execution and directed it to reduce the management fee payable to M&D by the excess portion of the fixed commission. Third, the Fund could have executed portfolio transactions on the regional exchanges and had Eberstadt or M&D, as members of the NASD, receive give-ups before December 5, 1968, or qualify for "preferred rate non-membership" status and a reduced rate of commissions thereafter.

Well aware of this possibility of recapture, the board of directors of the Fund, with the concurrence of the unaffiliated and non-interested directors, consistently directed that Eberstadt not act as broker in the execution of Fund portfolio transactions nor receive give-ups from other brokers in connection with Fund portfolio transactions.

Plaintiff, a shareholder of record of the Fund continuously since at least 1965, seeks to hold M&D, Eberstadt, and Zeller liable to the Fund for their part in implementing this decision of the unaffiliated and non-interested directors to forego recapture.[12] Jurisdiction was laid under section 44 of the Investment Company Act of 1940, as amended, 15 U.S.C. §80a-43; section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa; and section 22 of the Securities Act of 1933, 15 U.S.C. §77v.

Plaintiff first contended that by causing the Fund to forego recapture and allocate commissions to reward brokers who sold Fund shares and supplied it with research and statistical information, the defendants violated the

12 Chemical Fund, Inc. is a nominal defendant and appellee in this action, but our references to "defendants" and "appellees" will not include it unless specifically noted.

management and distribution agreements then in force between the Fund and M&D, provisions of the Fund's certificate of incorporation, and fiduciary duties imposed upon them by both the Investment Company Act of 1940 and common law. Plaintiff also claimed that the defendants failed to disclose accurately and fully to the unaffiliated or non-interested directors and to the shareholders the uses to which brokerage commissions were being put and the alternatives to those uses.

At the trial before Judge Carter, plaintiff rested her case in chief solely on the documentary evidence contained in 163 exhibits. The defendants called four witnesses: Zeller, Robert M. Maynard, a partner in Price Waterhouse & Company, auditors of the Fund; and Professors Roger F. Murray and Bertrand Fox, unaffiliated or non-interested Fund directors. In rebuttal, the plaintiff called Burt Dorsett, another independent[13] Fund director.

Judge Carter found "no basis for liability under either the federal securities law or the common law." 339 F. Supp. at 956. Accordingly, he entered judgment for the defendants dismissing the complaint. This appeal followed.

III.

On this appeal appellant contends (1) that the failure to recapture violated the Fund's advisory and distribution contracts with M&D; (2) that the failure to recapture violated the Fund's certificate of incorporation; (3) that the defendants breached their fiduciary duties to the Fund in their dealings with the independent directors regarding recapture; and (4) that the defendants violated the disclosure provisions of the securities laws by failing to keep

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13 The word "independent" hereafter will be used to describe directors who were neither "affiliated" nor "interested" within the meaning of the Investment Company Act. *See supra* at 4 and n.3.

the shareholders of the Fund properly informed as to the recapture problem. We will address these contentions seriatim.

A.

A key contention of appellant is that by allocating brokerage commissions and give-ups to reward dealers for selling shares and providing the Fund with research and statistical information, albeit at the direction of the independent directors on the Fund's board, the defendants violated the management and distribution contracts with the Fund. Appellant argues that, under these agreements, M&D was obligated to pay all the expenses relating to the promotion and sale of Fund shares and to provide research and statistical services to the Fund at its own expense. Through its allocation of the Fund asset of brokerage, appellant asserts, M&D profited at the expense of the Fund to the extent that it was able to avoid using its own funds to purchase sales promotion, research, and statistical services needed to discharge its contractual obligations. Appellant relies heavily on this allegation of self-dealing to support her other claims of breach of fiduciary duty and inadequate disclosure.

Appellees contend that both parties to the management and distribution agreements at all times contemplated that brokerage would be allocated by the investment adviser to obtain sales promotion, research, and statistical services. They claim that this understanding was in accordance with the generally prevailing method of business in the industry, and that this usage added implicit terms to the management and distribution contracts. Judge Carter found that the allocation of brokerage for these purposes was done

> with the unaffiliated directors having all the facts and specifically approving the practice . . . .

399 F. Supp. at 955. He concluded that the management and distribution agreements had not been violated.

The management and distribution agreements are silent on the subject of allocation of excess portfolio commissions. Since the industry usage of brokerage is not inconsistent with the pertinent provisions of the agreements,[14]

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14 The Fund's management agreement provided on January 1, 1965, and with minor changes not significant here continued to provide:

. . . .

2. The Manager shall furnish to the Board of Directors and officers of the Investment Corporation advice and recommendations with respect to the acquisition, by purchase, exchange, subscription or otherwise, of securities, and advice and recommendations with respect to other aspects of the business and affairs of the Investment Corporation; and shall, subject to the Board of Directors of the Investment Corporation, manage and supervise the business and affairs of the Investment Corporation.

3. The Manager shall supply the Board of Directors and officers of the Investment Corporation with all statistical information reasonably required by them and reasonably available to the Manager; shall furnish the Investment Corporation with an office, and with ordinary clerical and bookkeeping services at such office; and shall authorize and permit any of its directors, officers and employees, who may be elected as directors or officers of the Investment Corporation, to serve in the capacities in which they are elected. All services to be furnished by the Manager under this Agreement may be furnished through the medium of any such directors, officers or employees of the Manager.

. . . .

5. As compensation for the services performed and the facilities furnished by the Manager, including the services of any consultants retained by the Manager, effective January 1, 1965, the Investment Corporation shall pay the Manager . . . a quarterly fee, as per the following rates, of the average daily net assets of the Investment Corporation. . . .

The Fund's distribution agreement provided on January 1, 1965, and with minor changes not significant here continued to provide:

6. The Distributor shall assume and pay, or reimburse the Investment Corporation for, the following expenses of the Investment Corporation:

A. Costs of qualifying the shares of the Investment Corporation for sale and, if necessary or advisable in connection therewith, of qualifying the Investment Corporation as a dealer or broker, in

evidence as to its existence and the parties' awareness of it during negotiations was properly admitted to clarify the intentions of the parties, *Lowell* v. *Twin Disc, Inc.*, 527 F.2d 767, 770 (2d Cir. 1975), and to annex provisions in accord with the usage to those expressed in the agreements, 3 A. Corbin, Contracts §556 (1960); 5 S. Williston, Contracts §§648, 652 (3d ed. 1961). *Contrast Kama Rippa Music, Inc.* v. *Schekeryk*, 510 F.2d 837, 841-42 (2d Cir. 1975).

The uncontradicted testimony of defendant Zeller was that the amount of compensation awarded to M&D under the distribution contract

> was arrived at by a negotiation process in light of all of the circumstances, including the services which the adviser got from outside sources.

One of the "circumstances" he specified was the "known industry facts." He also testified that, while there was no explicit provision in the advisory contract which gave M&D the right to use a portion of brokerage commissions to reward firms that assisted it in providing research, such a provision "was implicit in the negotiation of the management fee." Zeller characterized the Fund's use of

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such states as shall be selected by the Distributor and fees payable to each state for continuing the qualification therein until the Distributor notifies the Investment Corporation that it does not wish such qualification continued.

B. Costs of printing all copies of the Prospectus and of preparing and printing all other sales literature, if any, printed at the instruction of the Distributor.

C. Counsel fees and expenses in connection with the foregoing.

The Distributor shall also pay all its own costs and expenses and, *generally*, all costs and expenses connected with the sale of shares of the Investment Corporation, excluding issuance, transfer and registry charges and taxes, delivery and remittance expenses, and the costs of stock certificates, except that, the Distributor shall pay all expenses incurred in connection with splitting the shares of the Investment Corporation. (emphasis added).

give-ups as "simply part of the brokerage practices of the times."

In response to a question concerning the compensation paid M&D under its management contract for research and statistical services, Dr. Roger F. Murray, an independent director of the Fund, testified as follows:

> The amount we were paying them was for what they could do, and they could not be an expert in all fields, and if they didn't have the benefit of those give-ups or commission business to use for getting outside additional facilities we would have had to raise their fee and make . . . arrange for them to buy them, because we were convinced it was essential to the performance of the fund that that kind of exposure to other ideas get into the decision-making process of the fund.

He stated that while no explicit contractual provision authorized such use of brokerage, it was "fully understood that that would be done," and was made "explicit and clear in the prospectus and in the proxy statements. . . ." The record fully supports this assertion.[15]

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15 The 1965 prospectus stated that "brokerage business is allocated to dealers partly on the basis of Fund shares sold and partly on services rendered." Subsequent prospectuses included similar statements as well as specification of the dollar amounts or, in 1972, percentages of brokerage allocated to dealers on the basis of shares sold and services rendered. The 1973 prospectus stated, as was then the case, that selection of brokers by the Fund was made "strictly on the basis of the value and quality of the brokerage services rendered," rather than on the basis of sales promotion. The proxy statements from 1966 on made corresponding, although more limited, disclosures.

These contemporaneous disclosures obviously support the conclusion that the rate of M&D's compensation under the advisory and distribution contracts was fixed with the knowledge that M&D would allocate brokerage to reward dealers providing it with additional research and sales promotion for the Fund's benefit. The whole course of dealing between the adviser and the Fund is to the same effect.

Appellant adduced no evidence to rebut the testimony that the allocation of brokerage business and give-ups by M&D on the basis of shares sold and services rendered was customary in the industry and specifically contemplated by the Fund's management and distribution agreements. Appellees' evidence to this effect stands uncontradicted and, on this record, the conclusion that the agreements were not violated is sustained.[16] *Compare Moses* v. *Burgin*, 316 F. Supp. 31, 59-60 (D. Mass. 1970), *rev'd on other grounds*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971).[17]

B.

Appellant's next argument can be disposed of briefly. Relying on *Moses* v. *Burgin*, *supra*, at 374, she contends that defendants' allocation of commissions to compensate dealers for sales promotion and research violated an express provision of the Fund's certificate of incorporation

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16 It is worth noting that while the SEC took no position on the interpretation of the Fund's advisory contract in its amicus brief, it acknowledged that

> most advisory contracts in the mutual fund industry contained relatively standard provisions, including one on research, and . . . it was nevertheless the general practice in the industry to pay for research with excess brokerage commissions.

Even appellant conceded in her reply brief that the practice was widespread in the industry, although she contends that most mutual funds chose not to defend it when challenged by litigation.

17 Unlike Judge Wyzanski, we believe that, unless the parties agreed otherwise, industry usage supplied the management and distribution contracts with additional terms authorizing the allocation of brokerage and give-ups by the investment adviser to promote sales and obtain services so long as this was legally permissible. We also conclude, however, that the contracts as thus construed do not violate section 15 of the Investment Company Act, 15 U.S.C. §80a-15.

that requires it to receive not less than "net asset value" for each share sold.[18] The *Moses* court observed that

> [i]f Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than asset value. The existing shareholders have contributed—by paying more than otherwise necessary on Fund's portfolio transactions—to the cost of the sale, which was supposed to have been borne by the new member alone.

445 F.2d at 374.

In *Fogel*, Judge Friendly rejected this reasoning and held that

> [a]lthough the argument is not without force, we think it presses too far. The term "net asset value" is one of art in the mutual fund industry and is elaborately defined in the certificate of incorporation. The objective of the charter provision was to prevent dilution of per share net asset value by the issuance of new shares at a discount; defendants' failure to recapture part of the commissions on portfolio transactions does not result in such dilution. Plaintiffs' real complaint is not that new shareholders did not pay net asset value but that the Adviser, for selfish motives, refrained from handling portfolio transactions in a manner that would have diverted a portion of the commissions to itself, with an attendant decrease in the

18 Article Eighth, Section B 5(b) of the Fund's charter, has at all times provided that the board of directors shall have power to authorize the issuance or sale of shares—from time to time—"for a consideration, per share, to the [Fund] not less than the asset value, per share, of the outstanding shares of the [Fund]."

> advisory fee—in substance a charge of breach of a fiduciary duty resulting in corporate waste.

533 F.2d at 744-45.[19]

His holding is equally applicable in the case at bar and disposes of this contention of the appellant.

C.

Appellant next contends that the conduct of the defendants in implementing the Fund's decision to forego recapture constituted a breach of fiduciary duty under both the Investment Company Act and common law.[20] To resolve this issue, we must determine whether the Investment Company Act imposed on the Fund and the persons who controlled it an absolute duty to recapture excess brokerage commissions, and, if not, whether the decision to forego recapture here is justifiable as proper exercise of the informed discretion reposed in the board of directors of a mutual fund under the Act.

Section 36 of the Investment Company Act of 1940, which prohibited "gross misconduct or gross abuse of trust" as originally enacted, 54 Stat. 841, and "breach of fiduciary duty involving personal misconduct" as amended in 1970, 15 U.S.C. §80a-35, established a federal standard of fiduciary duty in dealings between a mutual fund and its ad-

19 Judge Friendly also noted a comment on *Moses* which questioned the soundness of this "charter" argument in view of the fact that the First Circuit in that case apparently rested its finding of liability on the lack of full disclosure to the independent directors, rather than on the charter provision alone. *See Fogel* v. *Chestnutt, supra,* at 744 n.12.

20 Since we find the standards applicable to fiduciaries under the Investment Company Act at least as stringent as those at common law, *see Galfand* v. *Chestnutt Corp., supra,* slip op. at 416, we shall restrict our consideration of appellant's breach of fiduciary duty argument to the standards laid down by the Investment Company Act.

viser. *Fogel* v. *Chestnutt, supra,* at 745, citing *Brown* v. *Bullock*, 294 F.2d 415, 421 (2d Cir. 1961), and *Rosenfeld* v. *Black*, 445 F.2d 1337, 1345 (2d Cir. 1971), *petition for cert. dismissed*, 409 U.S. 802 (1972). In its original form, this section authorized SEC injunctive actions and, by implication,[21] private damage actions by investors against fiduciaries who failed to meet its standards. The remedial 1970 amendment of the section added a subsection (b) which explicitly granted a private right of action to recover unreasonable compensation paid by a fund to its investment adviser. Congress did not intend this modification to abrogate the private action already recognized under the Act for other types of breach of fiduciary duty. *See Fogel* v. *Chestnutt, supra; Moses* v. *Burgin, supra,* at 373, 373 n.7, 384; S. Rep. No. 184, 91st Cong., 1st Sess. 16 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 38 (1970). *But see Monheit* v. *Carter*, 376 F. Supp. 334, 342 (S.D.N.Y. 1974). Consequently, appellant's claim of breach of duty under the Act is properly before the court.

We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors. Nor do the opinions in *Fogel* and *Moses* suggest that the Act compelled recapture of commissions for the Fund's direct cash benefit as a matter of law.

It is true that, in response to the management's argument that even if recapture were practical the directors still had a right to choose between recapture of give-ups

21 *Tanzer* v. *Huffines*, 314 F. Supp. 189 (D. Del. 1970); *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

for the fund's direct benefit and awarding them to brokers for its indirect benefit, the *Moses* court stated that "if recovery was freely available to [the fund], the directors had no such choice." 445 F.2d at 374. This conclusion, however, was based solely on the First Circuit's interpretation of that fund's charter as mandating recapture, *see supra* at 21, and not upon the fiduciary obligations imposed under the Investment Company Act. When the question of the fiduciary duty of the investment adviser under the Act was addressed in *Moses* and *Fogel*, the inquiry of both courts was into the adequacy of the disclosure of the possibilities of recapture by the managers to the independent directors of the mutual fund. Plainly, such full and effective disclosure was required so that the independent directors could exercise informed discretion on the question of recapture *vel non*, thus performing the watchdog function envisaged for them by Congress.[22] *See, e.g., Moses* v. *Burgin, supra,* at 383; *Fogel* v. *Chestnutt, supra,* at 749-50. The violation of section 36 perceived in both cases resulted from management's failure to disclose sufficiently to the independent directors the possibilities of recapture, and not from the breach of an absolute duty to recapture imposed by the Act.

While we thus conclude that the Investment Company Act did not remove the recapture decision from the discre-

22 We note that after observing that "a change from independent brokerage to an affiliated broker is not a matter to be lightly undertaken," 445 F.2d at 374, the *Moses* court stated that sound business reasons supported the judgment of the fund's directors that portfolio transactions should not be executed through an affiliated broker. 445 F.2d at 375. *See also Schlusselberg* v. *Colonial Management Associates, Inc.*, 389 F. Supp. 733, 737 (D. Mass. 1974). The *Moses* court also rejected the contention that it was unlawful to allocate "reciprocals" to unaffiliated brokers "in proportion to their success in selling . . . shares to the public," so long as the mutual fund obtained best execution. 445 F.2d at 372 n.5.

tion of the Fund's board of directors,[23] such discretion is by no means unrestrained. As previously mentioned, independent directors can perform their function under the Act only when they exercise informed discretion, and the responsibility for keeping the independent directors informed lies with the management, i.e., the investment adviser and interested directors. *See, e.g.*, 15 U.S.C. §80a-15(c). This responsibility is particularly pressing when the matter in question is one on which the interests of the management and the mutual fund may be at odds. As stated by Judge Aldrich in *Moses*:

> Whatever may be the duty of disclosure owed to ordinary corporate directors, we think the conclusion unavoidable that Management defendants were under a duty of full disclosure of information to these unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund. This duty could not be put more clearly than was stated by the SEC in 1965.
>
> "The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company." Imperial Financial Services, Inc. CCH Fed. Sec. L. Rep. ¶77,287 at 82,464 (SEC 1965).

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23 In her supplemental brief, appellant somewhat surprisingly states that it has never been plaintiff's contention that Section 36 (or Section 36(a), as amended) removes the question of recapture *as a matter of statutory law* from the ambit of directors' discretion.

> Except where it may be fairly assumed that every unaffiliated director will have such knowledge, effective communication is called for. And, in testing that assumption, it must be borne in mind that they are not full time employees of the fund and it may be—as with Fund's unaffiliated directors—that neither their activities nor their experience are primarily connected with the special and often technical problems of fund operation. If management does not keep these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended. The only question can be whether the matter is one that could be thought to be of possible significance.

445 F.2d at 376-77.

Fogel recognized that PPI had raised such a question which "could be thought to be of possible significance" and on which the interests of a mutual fund and its adviser were in clear conflict. 533 F.2d at 749. Consequently, the investment adviser was obliged to disclose fully in order to assure that the independent directors supplied an independent check on management and adequately represented and protected the shareholder in fund decisions. Assuming such disclosure, Judge Friendly concluded that

> [the] minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. . . .
>
> If this had been done and the independent directors had concluded that, because of legal doubts, business

considerations or both, the Fund should make no effort at recapture, we would have a different case. But when there has been inadequate communication to the independent directors, it is no defense to the Adviser and those exercising control over it that a decision not to recapture, taken after proper communication, would have been a "reasonable business judgment."

533 F.2d at 749-50 (footnotes omitted).

Thus the decision to forego recapture here did not violate the fiduciary obligations of either the Fund's adviser or directors under section 36 of the Investment Company Act if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors.[24] We now turn to the record in this case to see if these conditions were met.

• • •

The documentation of the disclosure to the independent directors on the subject of recapture begins with the issuance of PPI by the SEC on December 2, 1966. Copies of the report were distributed to the directors of the Fund, as was a December 5, 1966 memorandum from M&D assessing PPI's impact. This memorandum pointed specifically to the SEC proposal to preclude give-ups. It was followed almost immediately, on January 9, 1967, by a second memorandum from M&D to the directors. M&D there noted that

24 This is the test proposed by the SEC, and we find that it encompasses both the *Moses* test of the adequacy of the disclosure of the possibilities of recapture by the adviser to the independent directors, and the *Fogel* test of the "minimum requirement" for the discharge of the independent directors' duties after such disclosure has been made.

"Chemical Fund's turnover rate is substantially below not only the mutual fund average but the average rate for the entire Stock Exchange," and made the following summary of the PPI proposal to prohibit give-ups:

> We believe, therefore, that the recommendations of the SEC would benefit both funds in that the volume discount would reduce the cost of operation and the elimination of give-ups would make the funds more competitive from a sales standpoint since they would be purchased on a performance basis rather than a reciprocal business basis, a practice in which Chemical Fund has not been competitive with the industry because of the low amount of brokerage commissions available. *The SEC apparently looks with favor on the practice of using brokerage business on portfolio transactions to reduce the cost of management.* It strongly endorses the method of operation of the Broad Street complex in which the partners of J. & W. Seligman receive substantial profits from the brokerage business carried out for the investment companies in that complex. It does not refer in this connection to the risks of excessive portfolio turnover nor to the pending derivative stockholder suits against this complex based on the theory that the funds could save money by using the third market or direct trades. The Report also points out that IDS is now a member of the Pacific Coast Exchange with the fund receiving the full profit on this brokerage business and the fact that the United Fund Group is also a member of the Pacific Coast Exchange with the fund receiving 50% of the profit. They refer to the fact that the brokerage subsidiaries do substantial amounts of Pacific Coast Exchange business for brokers who execute orders for the funds on other exchanges. (emphasis added).

The memorandum ended with a recommendation that the fund "continue the practice of using give-ups until such time as the SEC or Congress shall rule against that practice."

By October 17, 1967, M&D determined that in order to help formalize the board's annual consideration of the management and distribution contracts, it would prepare a memorandum outlining the comparative performance record of the Fund, comparative cost of operation, and the use of brokerage commissions to secure sales, research, and other services. M&D was by then fully aware, because of actions taken by both the SEC and competitor funds, that the board of directors itself should consciously make the decision whether or not to recapture.

Consequently, at the November 29, 1967 board meeting of the Fund, the chairman, the late Ferdinand Eberstadt, suggested that the independent directors consider appointing a subcommittee to review the operations of the Fund and M&D with a view toward reporting to the board prior to its next consideration of renewal of the management and distribution agreements. The independent directors chose from their number a subcommittee consisting of Dr. Murray and Mr. Dorsett to conduct such a review of operations.

On January 26, 1968, SEC Securities Exchange Act Release No. 8239, announcing proposed rule 10b-10 which would have mandated recapture when possible, see *supra* at p. 6273, was issued. The subcommittee of the Fund's board reviewing operations, Murray and Dorsett, then requested Sullivan & Cromwell, counsel to the Fund, and also to Eberstadt and M&D, to review the Fund's brokerage practices.

Sullivan & Cromwell responded with an opinion letter to the board dated February 20, 1968, which follows in its entirety:

You have asked us to review the method by which F. Eberstadt & Co., Managers & Distributors, Inc. (the "Manager") places brokerage orders for Chemical Fund, Inc. (the "Fund") and directs the allocation of a portion of the brokerage commissions arising therefrom to brokers other than the broker executing the order. As you know, F. Eberstadt & Co., the sole stockholder of the Manager, became a member of the New York Stock Exchange in 1962 and, since that time, as a matter of policy, has not executed brokerage orders for the Fund or requested or received "give-ups" on business done for the Fund by other brokers on the New York or other stock exchanges.

We have reviewed Securities Exchange Act Release No. 8239, dated January 26, 1968, which discusses, among other things, the level and structure of commission rates on the New York Stock Exchange, the practice of reciprocity and "give-ups", and the possibility of a manager receiving commissions or "give-ups" in connection with a fund's portfolio transactions in reduction of the management fee by all or a portion of such brokerage commissions or "give-ups". The Release also proposes the adoption of Rule 10b-10 under the Securities Exchange Act of 1934. We understand that you have received a copy of this Release. We have also examined the Investment Company Act of 1940 and such other matters of law as we have considered appropriate.

On the basis of the above and assuming that the Board of Directors has considered all the relevant facts concerning this matter, including the possibility of adopting alternate methods of handling the Fund's brokerage business whereby a portion of the commissions might be used to reduce the management fee, and assuming further that, as a result of such consid-

eration, the Board of Directors has come to the conclusion as a matter of reasonable business judgment that it is in the best interest of the Fund and its shareholders that the continuation of the present method of placing brokerage orders and directing "give-ups" be approved, it is our opinion that such approval would be lawful.

The board of directors of the Fund met on February 21, 1968, and the subcommittee previously appointed to review the operations of the Fund and M&D prior to the board's consideration of the management and distribution agreements submitted its report in writing. In this and subsequent years M&D furnished this subcommittee with copies of its financial statements for several preceding years, and various schedules comparing the expenses of M&D with other publicly owned companies in the field and the Fund's performance and expense ratio with those of certain other common stock growth funds. M&D also reviewed with the subcommittee the amount of portfolio brokerage commissions and the method of allocating such commissions. In addition, the subcommittee considered the opinion letter of Sullivan & Cromwell regarding the various matters referred to in SEC Securities Exchange Act Release No. 8239.[25]

The Murray/Dorsett report went into a lengthy consideration of what use should be made of brokerage commissions:

> In Release No. 8239 dated January 26, 1968, the SEC discusses the level and structure of commission rates on the New York Stock Exchange, the practice of reciprocity and "give-ups" and the possibility of a manager receiving commissions or "give-ups" in connection with a fund's portfolio transactions in reduction of the management fee by all or a portion of such brokerage commissions or "give-ups". We have studied this Release and the proposal to issue Rule 10b-10 on the subject of give-ups and we also read the opinion of Messrs. Sullivan & Cromwell addressed to the Board of Directors of Chemical Fund dated February 20, 1968 dealing with this subject.
>
> In 1967, as fully disclosed in the proxy statement, the Fund paid brokerage commissions of $618,000. Of this amount, $510,000 was allocated to dealers based on the volume of Fund shares sold. The allocation of brokerage business and the use of directed give-ups can be regarded as additional compensation to dealers who sell Fund shares. This is a long established practice of the business, which has been followed by Chemical Fund with the full knowledge of the Board and the stockholders. In addition to the information regularly provided in proxy statements, prospectuses and Form N-1R, the manager has reported from time to time and the Board has approved these practices. The specific allocations to individual brokers are made by the fund's officers without prior review by the directors but in accord with the general policy approved by the Board.
>
> We quote from the SEC release as follows: "Many mutual fund managers believe that so long as this type of sales incentive can be given to dealers, competition among mutual fund managers for the favor of dealers will make it difficult, if not impossible, for any individual fund manager to fail to provide such compensation to dealers, both members and nonmembers of exchanges, selling shares of his funds." We

25 Copies of the release and opinion letter were forwarded to each director.

agree completely with this statement. Regardless of the merits of this method of doing business, it is not practical to attempt a change for Chemical Fund at this time even though we recognize that it would be possible to request the manager to execute some portfolio transactions as a member of the New York Stock Exchange or request give-ups on portfolio transactions which would be credited against the amount of the management fee.

We believe that the directors must look upon this question realistically and in proper perspective. Chemical Fund has a very low portfolio turnover rate. The Board retains close control over that rate of turnover. We are mindful of the fact that through the portfolio committee as presently constituted the unaffiliated directors have, in effect, power over portfolio transactions and this power has been frequently exercised. Therefore, management does not really exercise complete control over the generation of commission business for the purpose of stimulating sales. While we recognize fully that allocation of the purchase and sale orders is an additional resource to the distributor, we are not impressed with either its size or the possibility of abuse. We propose, therefore, no change in this arrangement and recommend approval of a continuation of the past practice of leaving the allocation of brokerage commission business to the officers of the Fund.

The report concluded by recommending renewal of the existing contracts for another year.

The interested directors withdrew from the meeting during the discussion of the management and distribution agreements. After discussion, the board, with only independent directors voting, unanimously approved the con-

tinuance until March 31, 1969 of the existing management and distribution agreements.

At a board meeting on July 17, 1968, Dr. Murray made reference to hearings being conducted by the SEC with respect to the level of NYSE commission rates and the use of give-ups by mutual fund managers and distributors. He reminded the board that this subject had been dealt with in the February 21, 1968 subcommittee report, and stated that he saw no reason to make any change in the practice of leaving the allocation of brokerage business to the officers of the Fund, as recommended in that report. After discussion, the unaffiliated directors again unanimously approved the continuation of this practice.

On December 5, 1968, the constitution of the NYSE was amended to prohibit customer directed give-ups. In a cover letter dated January 10, 1969 which accompanied the material furnished for the annual review of operations, Francis S. Williams, then chairman of M&D, informed the Murray/Dorsett subcommittee that the use of give-ups was abandoned on December 5, 1968 to conform to the new NYSE stance. He also suggested to the unaffiliated directors that it was in the best interests of the Fund and its shareholders

> to have the Manager direct the brokerage business in such a way as to obtain the best price and execution. However, in selecting such brokers the extent to which such dealers have sold shares of the Fund or have provided statistical and research information will continue to be important factors.

The subcommittee's written report of February 19, 1969 accepted this recommendation.

The cover letter from M&D of January 9, 1970 and the subcommittee's report of January 22, 1970 were similar to

their 1969 counterparts,[26] and basically recommended continuation of existing policies. At a board meeting on February 18, 1970, the unaffiliated directors, relying on this subcommittee report, unanimously adopted a new management agreement and approved the continuance of the existing distribution agreement.

The cover letter of January 15, 1971 accompanying the material furnished by M&D to the subcommittee to review operations stated that a summary of Judge Wyzanski's district court opinion in *Moses* v. *Burgin*, *supra*, had been recently distributed to the board of directors. The district court there held that the decision to recapture or not was a matter of business judgment for the board of directors, and that the board members did not breach their fiduciary duties by permitting portfolio brokerage to be used to acquire statistical information and assist sales—provided that best execution was obtained. The letter pointed out to the subcommittee the possibility of recapture, but recommended that the unaffiliated directors continue the current use of brokerage commissions. The subcommittee to review operations, which now consisted of Murray and Driscoll, prepared a written report to the board dated February 17, 1971 which recommended no change in the method of directing brokerage business. It noted that, because of a relatively low rate of portfolio turnover, the volume of commissions paid was small for a mutual fund of Chemical Fund's size, and reasoned that

> [w]ith so many proposals under discussion regarding negotiated commission rates, institutional membership,

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26 In the interim, SEC Securities Exchange Act Release No. 8746, the Loomis letter stating that management has no fiduciary duty to acquire a stock exchange seat for recapture purposes if its best business judgment is to the contrary, *see supra* at 8, had been issued.

> and the possibility of "unbundling," we believe that it would be unwise to alter present arrangements.

The report also suggested, however, that the subject of brokerage allocation "be reviewed promptly in light of any developments during the year."

At the board meeting of June 16, 1971, the chairman, Williams, referred to the First Circuit's decision in *Moses* v. *Burgin*, copies of which had been previously mailed to the directors. Copies of the Sullivan & Cromwell opinion letter dated February 20, 1968 were again distributed to the board at the meeting. Williams suggested that in the light of Judge Aldrich's decision it would be advisable to appoint a committee of unaffiliated directors to again review the Fund's practices with respect to brokerage, to consult with Sullivan & Cromwell regarding brokerage practices, and to consider the various alternatives available. A committee of independent directors, consisting of Dr. Murray as chairman, Driscoll, and Fox, was then appointed.

On July 21, 1971, Robert C. Porter, then president of the Fund, reported to the board that a meeting had been scheduled with the NYSE to explore the question of whether it would be permissible, if the Fund did some of its brokerage business with Eberstadt as a member of the Exchange, to credit a portion of the commissions against the management fee payable by the Fund. He also reviewed a proposed settlement, involving recapture by means of executing portfolio transactions on regional exchanges, in a case against two other funds.

On July 30, 1971, Porter received from David D. Huntoon, assistant vice-president and associate director of the NYSE, a proposed "Educational Circular" stating the Exchange's position on using commissions to reduce investment advisory fees. In essence, the circular stated that

this was not a prohibited rebative practice "to the extent that the investment advisory fee is for investment advice or other services routinely covered by commissions." The letter from Huntoon accompanying the proposed educational circular stated that a meeting could be arranged to discuss the circular's contents.

On August 5, 1971, *"The Securities Markets* A Report, With Recommendations" by William McChesney Martin, Jr. (the Martin Report), was submitted to the Board of Governors of the NYSE. This study, in sharp contrast to existing NYSE practice as illustrated by the July 30, 1971 proposed Educational Circular, recommended prohibition of member firm management of mutual funds as well as institutional membership, and prohibition of crediting commissions against any fee charged for investment advice. Martin Report at 25.

The Martin Report thus added several more pieces to the recapture puzzle. M&D sent a memorandum to the subcommittee appointed to review the Fund's brokerage practices on August 17, 1971. It indicated that management was still reviewing with the NYSE the permissibility under its rules of using a portion of brokerage commissions to reduce advisory fees, and that Sullivan & Cromwell was exploring the possibility of working out such an arrangement through the Pacific Coast Stock Exchange or other regional stock exchanges by means of some form of preferred rate arrangement for NASD members. It also raised several other "unsettled" factors for the subcommittee's consideration:

1. The Martin report has just been issued and recommends that members of the NYSE spin-off the management of investment companies from the brokerage business.

2. The 1970 amendments to the Investment Company Act directed the NASD to consider the scale of

distribution fees for registered investment companies and this study is now in progress.

3. The present commission rate structure of the NYSE is now under review by the SEC.

4. The effect of negotiated commissions is still not fully developed and the question of whether the $500,000 level will be reduced to a substantially lower level is still to be determined.

5. The language of the Fidelity Management case [*Moses* v. *Burgin*] indicated that the directors may have no choice in these matters because of charter provisions and the question of whether the Certificate of Incorporation can be amended to give the directors such a choice is now being considered by counsel.

It concluded by expressing M&D's recommendation that the explorations of recapture arrangements with the NYSE and regional exchanges be diligently pursued, but that no final decisions changing the methods of distribution or handling brokerage business be made until some of the quoted uncertainties were clarified.

On December 13, 1971, M&D furnished the subcommittee to review operations, which now consisted of Murray and Coles, with its annual compendium of information on the Fund's performance. The cover letter indicated that Sullivan & Cromwell's research into the fifth "unsettled" factor resulted in its recommendation that the Fund's certificate of incorporation be amended "to make explicit the powers of the Board of Directors with respect to the determination of how portfolio brokerage of the Fund shall be used." It stated that the proposed amendments incorporated the board's policy of refraining from recapture—despite its recognition of available recapture techniques.

At a board meeting held on December 15, 1971, it was reported that a number of mutual fund management companies were currently obtaining preferred rate non-member status on regional stock exchanges in order to recapture part of the portfolio brokerage commissions for the benefit of their funds. It was pointed out that several lawsuits against management companies over brokerage practices were being settled on the basis that part of the portfolio brokerage would be recaptured through a NYSE affiliate of the manager or through preferred rate non-member status on a regional exchange. It was also stated that the SEC was expected to announce its position on this matter early in 1972 after the conclusion of hearings in Washington.

At the annual meeting of the Fund held on March 14, 1972, the stockholders were asked

> to consider and vote upon a proposal made by the Board of Directors to amend the Amended Certificate of Incorporation of the Corporation to clarify provisions thereof as to the powers of the Board of Directors in the allocation of portfolio brokerage for the Corporation.

By vote of a wide margin of the outstanding shares entitled to vote, a resolution so amending the certificate was adopted.[27] A proposed amendment to the management

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27 As amended, Section B of Article Eighth of the Amended Certificate of Incorporation provided the board of directors with the power:

> 8. To determine in their [sic] discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund and the selection of the brokers and dealers that shall receive or share directly or indirectly in any such commissions and the basis of such receiving or sharing therein, including, but not limited to, sales of shares of the Fund and any other funds having the same investment adviser and statistical and other information and wire and other services provided to the Fund or the Manager.

agreement providing that no brokerage business could be done with the firm of F. Eberstadt & Co. Inc. without the specific approval of a majority of the unaffiliated directors also carried.

The record shows that this pattern of periodic consideration of the recapture question continued during the

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The proxy statement dated January 27, 1972 stated that the purpose of this amendment was

> to make explicit that which has always been implicit, namely, that the Board of Directors of the Fund (more than 50% of whom are otherwise unaffiliated with the Fund or its Manager) has the power to determine how the portfolio brokerage of the Fund shall be used. In the opinion of the Board of Directors of the Fund, it is in the best interest of the Funde to continue the brokerage practices which it has followed since inception under which all portfolio transactions have been carried out by brokers who are not affiliated with the Manager and Distributor of the Fund and not to make any provision for recapture through an affiliated broker of any part of the brokerage commissions paid by the Fund.

Accordingly, as reflected in the proposed new Management Agreement discussed below, the Board of Directors has directed the Manager not to have the Fund purchase or sell any portfolio securities through the firm of F. Eberstadt & Co., Inc., the parent of the Manager, which is a member of the New York and American Stock Exchanges. As indicated under "Allocation of Portfolio Brokerage and Portfolio Turnover Rate" below in this proxy statement, the Fund's Board of Directors and the Manager consider that, subject to obtaining the best price, execution and commission, allocation of brokerage to dealers who have sold shares of the Fund or have provided statistical and research information has been and presently continues to be of benefit to the Fund and its shareholders. The Fund's Manager has been authorized by the Board of Directors to select in the Manager's discretion the brokers or dealers that shall execute portfolio transactions or share directly or indirectly in commissions with respect thereto, and to determine the basis of such sharing, subject in each case to obtaining the best execution taking into consideration, among other things, price (including any brokerage commission), size of the transaction and need for speed in execution. The Board, of course, would have the right to determine in the future that some other course of action might be desirable.

remainder of 1972 and in 1973 and 1974, with the possibility of recapture being raised by M&D, considered by the subcommittee of unaffiliated directors, and finally rejected by the unaffiliated directors as a whole.

Testimony elicted at trial to a large extent repeated what was already reflected in the documentary evidence. Certain gaps were, however, filled in.

Zeller testified that as early as the latter part of 1962 the possibility of offsetting give-ups against the management fee was "discussed and discussed with the board." He stated that the subject was thereafter "reexamined at least once a year, and I think oftener [sic]."

The main theme running throughout Zeller's testimony was that because of the Fund's relatively low portfolio turnover rate during the period of time covered by the complaint and throughout its history, it had less brokerage to allocate than its competitors and consequently was "at a very great disadvantage in getting sales cooperation. research cooperation, statistical information . . . ." He continued:

> Now, whether it was better to use that brokerage for those purposes or whether it was better from the standpoint of the stockholders to use some part of that brokerage to reduce the management compensation payable to Eberstadt was the closest kind of business decision, and it was made in favor of using the brokerage to protect the kind of performance that Chemical Fund has had since its inception.

Dr. Murray testified that the brokerage policy of the Fund, determined specifically by the independent directors, was to delegate to the manager the specific allocation of commission business within guidelines established by the board of directors. Those guidelines were that the manager was at all times to "seek best execution for the purchase or sale transaction," and that, subject to that overriding consideration, it was encouraged to use brokerage commission business prior to mid-1973 to stimulate sales of Fund shares, and, throughout the entire period,

> to secure statistical and other services and to obtain investment information, investment research recommendations from the broker-dealer community.

When asked how many times methods of recapture of brokerage commissions were discussed by the Fund's board, Murray replied:

> I don't believe I could accurately estimate the number of occasions, but, obviously, they were discussed annually at the time when we discussed renewal of the management and distribution contract, and then in between, as whenever we read or heard about or talked about some of the changes in or suggested changes in the regulatory environment or in legal decisions. So that there must have been three or four more other times a year in which these questions would be formally discussed at board meetings or at portfolio committee meetings or at the luncheon table.

He then enumerated the reactions of the board to specific regulatory and legal developments, including its view that it did not wish to follow the proposals made in the SEC release accompanying proposed rule 10b-10, its consultation with counsel to confirm the propriety of this view, and its subsequent satisfaction at the withdrawal of the proposed rule 10b-10 and what it perceived as a complete retreat by the SEC from its former position.

Murray testified at length concerning his reasons for being "unalterably opposed" to having Eberstadt act as

broker for the Fund or receive give-ups on its behalf. He stated that it "opened up the possibility of a conflict of interest situation" in which Eberstadt traders would have to choose between giving priority to the orders of the Fund or one of their other customers. He also saw conflict of interest problems in negotiating commissions at arm's length when a parent and subsidiary were both involved in a transaction.

Murray referred to a possibility that if Eberstadt alone were used to execute Fund portfolio transactions, other brokers might anticipate the Fund's investment decisions. He also said that if brokerage business were given exclusively or predominantly to Eberstadt,

> other broker-dealers would have no incentives to seek out the opportunity to perform services for Chemical Fund, to provide it with investment information, to provide it with statistical and other kinds of services that would be of assistance in the management of the portfolio.

Moreover, he asserted, up until mid-1973 brokerage allocations had been instrumental in producing the sales of new shares and accompanying positive cash flow. Murray viewed these as vitally important to the quality of performance of the Fund because they eliminated any need for untimely liquidation of portfolio investments in order to meet demands for redemption of existing shares.

The reputation of the Fund would also have been damaged by placing its commission business with Eberstadt or having Eberstadt receive give-ups on the Fund's behalf, according to Murray. Investors and the public would suspect churning of the portfolio in order to generate an enlarged volume of commission business.

Finally, Dr. Murray pointed to the "overriding consideration that the commission structure was not there to stay." He reasoned that

> under these circumstances, it would be an especially foolish step for the directors of Chemical Fund to take to impair the effectiveness of the ongoing organization for what was obviously going to be an extremely short-lived and temporary minor dollar saving to the fund . . . .

Murray confirmed that the board had considered preferred rate non-member status on regional exchanges, but that he had decided, prior to learning that this method of recapture was available, that it should not be used because placing portfolio transactions on regional exchanges "would damage . . . best execution." His reasoning became evident in the following exchange:

> The Court: Dr. Murray, . . . I want to be sure I understand the purport of your testimony. Were you as convinced that the giving of the execution contract to Eberstadt and obtaining give-ups from them would be so disadvantageous for the various reasons that you set out that you would not do so, unless you were convinced that you were compelled to do it by some rule or regulation of law? That is what I glean from your testimony. Is that correct?
>
> The Witness: That is precisely an accurate statement, sir. I think that exactly follows the thread of what I have been trying to say, and that is the reason why, for example, I was not interested in pursuing some of these avenues, because I had decided no matter what the avenue permitted, we should not do it in this Fund.

The testimony of Bertrand Fox, another independent director, corroborated that of Dr. Murray and enumerated basically the same reasons for foregoing recapture.[28]

(1)

As previously mentioned, it was stipulated by the parties that during the period in question a majority of the Fund's board of directors was neither "affiliated" nor "interested" within the meaning of the Investment Company Act. At the trial, appellant never seriously challenged the factual independence of these directors from M&D.

The record shows that while the independent directors received information on the possibilities of recapture and recommendations against it from M&D, all such material was presented in a neutral, even-handed fashion. *Contrast Fogel* v. *Chestnutt, supra; Papilsky* v. *Berndt*, 71 Civ. 2534 (S.D.N.Y., decided June 24, 1976).

The evidence demonstrates that the independent directors separately considered the subject, investigated it by way of their subcommittees, and arrived at their own conclusion that recapture should not be undertaken. This was a well-qualified board and its determinations did not merely rubber-stamp the recommendations of M&D. We conclude that the independent directors were not dominated or unduly influenced by the investment adviser.

(2)

In his opinion below, Judge Carter found that "[t]here is no evidence of nondisclosure by M&D to the unaffiliated directors in this case. . . ." 339 F. Supp. at 950. This finding of fact is fully supported by substantial evidence.

28 The testimony of Dorsett, a third independent director who was called in rebuttal by the plaintiff, shed little light on the board's deliberations.

The record demonstrates that M&D promptly brought every administrative, judicial, and legislative development pertaining to recapture to the attention of the Fund's board, including its independent directors. Such communication was "full" and "effective" under the *Moses* test, *see supra* at pp. 6294-6295, which governs disclosures by management to the fund when the interests of the two may conflict. The independent directors were fully aware early in the game that recapture was possible by having Eberstadt either execute portfolio transactions or receive give-ups, or by resort to a regional exchange technique, and we conclude that the second prong of the applicable test—that the independent directors were fully informed by the adviser and the interested directors of the possibility of recapture and the alternative uses of brokerage—has been met.

(3)

There remains the question of whether, under the standards laid down by Judge Friendly in *Fogel, see supra* at pp. 6295-6296, the independent directors reached a reasonable business judgment to forego recapture after being informed of all relevant factors and thoroughly reviewing them.

There were four principal business reasons which convinced the independent directors to forego recapture.[29] These reasons were (1) that recapture would have involved the Fund in conflicts of interest in fact and in appearance; (2) recapture would have an adverse impact on the sale of the Fund's shares; (3) it was in the best interests of the Fund to allocate brokerage for research; and (4) imminent changes in the structure of the securities industry made it unwise to change the Fund's long-standing brokerage policies against recapture.

29 *See* discussion of Dr. Murray's testimony, supra at p. 6288 and pp. 6310-6314.

The directors' view that recapture would have involved the Fund in conflicts of interest in fact and in appearance was based on several factors. It was feared that shareholders would suspect churning if the Fund used an affiliated broker to recapture and that consistent use of Eberstadt to execute portfolio transactions might permit other investors to anticipate Fund investment decisions. There was also concern that best execution would suffer if an affiliate were used as executing broker.

While the prospects of suspected churning and anticipation by others of Fund investment decisions were remote, they were not unreasonable apprehensions. Moreover, there was a real possibility that the obligation of obtaining the best execution might be jeopardized through close affiliation between a broker-dealer and the investment company,[30] and that possibility alone could warrant ruling out such a method of recapture. We note also that concern with eliminating any unnecessary appearance of conflicts of interest in an area already "fraught" with them, *Galfand* v. *Chestnutt Corp., supra,* slip op. at 410, is not an unreasonable supplementary business consideration.

The directors also feared that recapture would have an adverse effect on the sale of the Fund's shares. The question of how large a fund should become by increasing its sales is highly debatable. *Fogel* v. *Chestnutt, supra,* at 756 n. 33. The PPI report acknowledged that competitive considerations relative to sales might argue against recapture. Such considerations were stronger in the case of funds which, like Chemical Fund, had relatively low rates of portfolio turnover and thus little brokerage available for distribution as sales incentives in the first place. In addition, the directors felt that proceeds from new

30 This possibility was recognized as early as 1966 in the PPI Report. *See* PPI at 189-90.

sales were needed to avoid untimely portfolio liquidations and that, since there are economies of scale in managing a portfolio, an increase in the size of the fund would decrease the management costs per dollar. The board's conclusion that recapture might decrease the sale of shares and eventually harm the Fund's performance was reasonable.

The directors' judgment to continue the existing practice of allocating brokerage to obtain additional research was also reasonable. That general practice was confirmed in the Policy Statement of the SEC on the Future Structure of the Securities Market (February 2, 1972), 37 Fed. Reg. 5286, 5290. *See* also SEC Securities Exchange Act Release 9598 (May 9, 1972), containing an interpretation of the Future Structure policy statement on this point. Moreover, section 28(e)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §78bb(e)(1), which was added by the Securities Act amendments of 1975, permits an investment adviser to cause an account to pay a broker an amount of commission for effecting a securities transaction in excess of the commission another broker might have charged, as long as the adviser determines in good faith that the commission was reasonable in relation to the value of both the brokerage and research services provided by such broker.

Finally, the view of the directors that imminent changes in the structure of the industry made it unwise to change the Fund's brokerage policies may not be entitled to much weight. Nevertheless, in the light of the many and often contradictory administrative, legislative and judicial pronouncements on the subject of recapture, this is a factor to be taken into account when evaluating the reasonableness of the business judgment reached by the directors—which they recognized as a very close question.

The independent directors also sought the advice of counsel on the recapture question. It is true that such advice was not given by wholly disinterested counsel since Sullivan & Cromwell represented M&D and Eberstadt as well as the Fund itself. Thus, "it would have been . . . better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors." *Fogel* v. *Chestnutt, supra*, at 750. Here, however, counsel correctly advised the independent directors as to the applicable law and the necessity for reaching a reasonable business judgment on the recapture question. The fact that counsel were not disinterested does not vitiate the reasonableness of the judgment which the independent directors reached here. *See Fogel* v. *Chestnutt, supra,* at 749-50.

In its amicus brief, the SEC, although critical of some of the reasons advanced for the decision not to recapture, concluded that the reasons considered in the aggregate supported the directors' decision. Among the reasons which the SEC considered valid were the desirability of obtaining additional research, the possibly adverse effect of adopting a recapture policy on sales and on portfolio performance, and the requirement of obtaining the best execution.

It should be borne in mind that the question here is not whether, as a matter of hindsight, the determination of the independent directors was correct. The question is whether the decisions by these directors to forego recapture were reasonable considered at the time and under the circumstances in which they were reached.

We conclude that the *Fogel* test governing the determination of the independent directors not to recapture was satisfied in this case. There was full disclosure by the Fund's adviser as to the possibilities of recapture and the methods available to accomplish it. All material dealing

with the question was placed before the independent directors and fully considered by them. They were correctly advised by counsel as to the applicable legal standards. They carefully weighed the relative advantages and disadvantages of recapture and the economic pros and cons involved. Their decision to forego recapture was a reasonable business judgement.[31]

Since all three prongs of the applicable test have been met, we agree with Judge Carter that the decision to forego recapture did not violate the fiduciary obligations of either the Fund's adviser or its interested directors under section 36 of the Investment Company Act, and affirm his holding to that effect.

D.

Appellants' final contention is that the court below erred in not holding M&D, Eberstadt and Zeller liable to the Fund for the issuance to its shareholders of false and misleading proxy statements and prospectuses. In this derivative action, brought on behalf of the Fund, we see no basis upon which the Fund could recover for deficiencies in its prospectuses. We will, therefore, treat this contention as attacking only the adequacy of the proxy state-

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31 There is an important distinction between the case at bar and this court's recent decision in *Arthur Lipper Corp.* v. *SEC*, No. 76-4067 (2d Dir., decided Dec. 10, 1976). Here, the Fund's independent directors decided to use excess brokerage commissions generated by portfolio transactions to secure additional sales promotion, research, and other services. They recognized, when negotiating the management and distribution contracts, that this might provide M&D with some incidental advantages, but concluded that this use of brokerage would confer greater benefits on the Fund than an immediate reduction in the advisory fee. In contrast, the arrangement in *Lipper* "was a bald diversion to the manager of sums belonging to the investment company", *Arthur Lipper Corp.* v. *SEC, supra*, slip op. at 916, with the mutual fund receiving no arguable benefit in return.

ments. *See Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *Galfand* v. *Chestnutt Corp., supra.*

It is charged that proxy statements issued to the Fund's shareholders omitted to state material facts as to the opportunities to recapture portfolio brokerage commissions for the benefit of the Fund, the methods available for such recapture, and the board's decisions to forego recapture. The material facts so omitted, says the appellant, were necessary in order to make the proxy statements not false and misleading within the meaning of SEC rule 14a-9, 17 C.F.R. §240.14a-9(a), as made applicable to investment companies.[32]

The question of the adequacy of the information furnished to shareholders in proxy statements is not disposed of by our holding that the defendants did not breach their fiduciary duties relative to the decisions of the independent directors to forego recapture. The management of an in-

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32 As Chief Judge Kaufman stated in *Galfand, supra,* at n.14:

> Rule 14a-9, 17 C.F.R. §240.14a-9(a) was promulgated by the Securities and Exchange Commission pursuant to §14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78n(a), and provides:
>
> §240.14a-9 False or misleading statements.
>
> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.
>
> The Rule is pertinent here by virtue of Section 20(a) of the Investment Company Act, 15 U.S.C. §80a-20(a), and the Commission's Rule 20a-1, 17 C.F.R. §270.20(a)-1, making the proxy rules applicable to securities issued by registered investment companies.

It may be noted that the SEC's amicus brief did not address the issue of the adequacy of disclosure to the shareholders.

vestment company also is obliged under rule 14a-9 to furnish its shareholders with all information necessary to enable them to make an informed judgment on questions concerning investment contracts presented to them at annual meetings. See *Galfand* v. *Chestnutt Corp., supra,* slip op. at 418; *Mills* v. *Electric Auto-Lite Co., supra,* at 381. We must therefore examine the various proxy statements to determine whether or not they conform to the requirements of rule 14a-9.

In 1966, 1970, 1971, 1972, and 1973, new investment advisory contracts with M&D or renewals or amendments of existing contracts were submitted for approval by the Fund's shareholders at annual meetings pursuant to section 15(a) of the Act, 15 U.S.C. §80a-15(a). The shareholders also had the statutory right at any time to terminate the current advisory contract or seek its renegotiation under section 15(a)(3). *Brown* v. *Bullock, supra,* at 417. In all the years from 1966 to 1974, inclusive, the proxy statements issued for the annual shareholders meetings contained statements concerning the M&D management contract and the Fund's portfolio brokerage practices. Directors of the Fund were also elected by the shareholders annually.

The February 4, 1966 proxy statement, issued before the publication of PPI by the SEC, devoted the following separate section to the subject of Fund brokerage:

> For the year 1965, brokerage fees paid by the Fund on the purchase and sale of the Fund's portfolio securities amounted to $339,860. There is no undertaking or agreement to allocate such business to dealers on any prescribed basis. However, the extent to which such dealers have sold shares of the Fund or have provided statistical research or other services are important factors in such allocation. Subject to obtaining

the best execution, $271,910 was allocated to dealers based on the volume of Fund shares sold and $40,977, representing approximate value, to dealers who provided statistical research or other services to the Manager. The Manager has informed the Fund that these services do not reduce the expense of the Manager by a material amount. Officers of the Fund are responsible for the allocation of brokerage business and placement of brokerage orders.

It is the current intention of the Fund to continue the practice set forth above. However, it is the policy of the Fund that no brokerage business will be placed with any dealer if, in the opinion of the Fund the most favorable price and execution would not be obtained.

The February 7, 1967 proxy statement, issued some two months after PPI, and the February 9, 1968 proxy statement, contained brokerage sections nearly identical to the 1966 version except for the specific figures reported.

The February 10, 1969 proxy statement followed this pattern in practically identical language. In addition, it provided information as to the Fund's portfolio turnover rate for the past three years and stated:

> While the Fund does not presently intend to purchase or sell any securities through the firm of F. Eberstadt and Co., it may do so in the future but, if so, only in its capacity as broker with respect to transactions on a securities exchange at regular exchange commissions and charges.

The February 19, 1970 and March 31, 1971 proxy statements were virtually identical to their 1969 counterpart on the subject of portfolio brokerage.

The January 27, 1972 proxy statement contained a separate section proposing an amendment to the Fund's certificate of incorporation designed to make explicit what was said to be the implicit power of the board of directors to determine how portfolio brokerage commissions should be allocated. *See supra* n. 27. The statement announced that the board intended to continue existing brokerage practices and did not plan to

> make any provision for recapture through an affiliated broker of any part of the brokerage commissions paid by the Fund.

This was the first mention of recapture possibilities in any of the proxy statements.

In addition, the 1972 proxy statement contained a somewhat expanded discussion of portfolio brokerage and portfolio turnover rate:

> Brokers receive commissions at standard rates on portfolio transactions up to $500,000 and at negotiated rates on transactions in excess of this amount since April 1, 1971. For the fiscal year ended December 31, 1971 brokerage fees paid by the Fund on the purchase and sale of the Fund's portfolio securities amounted to $920,767. The Fund has also executed portfolio transactions with dealers acting as principals in the "third market" and directly with institutions in the "fourth market". The Fund does not deal exclusively with any particular broker-dealer or group thereof. The Fund always seeks to place portfolio transactions where it can obtain the best net price which results from the most favorable combination of price, commission and execution and deals directly with a principal market maker in connection with over-the-counter transactions. The Fund's Board of Directors and the Manager consider that, subject to obtaining the best price, execution and commission, allocation of brokerage to

brokers who have sold shares of the Fund or have provided statistical and research information is, and presently continues to be, of benefit to the Fund and its shareholders. In many instances the broker who provides the best execution also provides statistical and research information and also may have sold shares of the Fund. To the extent possible, the Manager selects broker-dealers who have provided a broad range of services to the Fund. It is impossible therefore to determine the precise amount of brokerage that was allocated for any single service. Officers of the Manager, who are also officers of the Fund, are responsible for the allocation of brokerage business and placement of brokerage orders, subject at all times to obtaining the best price and execution. The Fund's portfolio turnover rate, exclusive of short-term notes, for the last three fiscal years was 10.3% for 1969, 12.1% for 1970 and 13.2% for 1971.

> As indicated above, the Board of Directors has directed the Manager not to have the Fund purchase or sell any portfolio securities through the firm of F. Eberstadt & Co., Inc., the parent of the Manager. The Board, of course, has the right to determine in the future that some other course of action might be desirable.

The final two proxy statements with which we are concerned, dated February 7, 1973 and February 8, 1974, respectively, reflected the amendment to the Fund's certificate of incorporation in 1972 and the NASD rule change in 1973. They informed the shareholders that the Fund's board had the power, under the certificate of incorporation, to determine brokerage policy; that the board had instructed M&D that sales of Fund shares should not be

a qualifying or disqualifying factor in the selection of brokers who executed portfolio transactions; that the choice must be made strictly on the basis of the value and quality of the brokerage services rendered; and that in many instances the brokers selected may have provided statistical and research information and may or may not have sold shares of the Fund. They also repeated the statement that the board had directed M&D not to have the Fund purchase or sell any portfolio seecurities through the Eberstadt firm, although it had the right to determine some other course of action in the future.

At trial, Zeller testified that the shareholders were not advised that up to 1968 give-ups were being directed to brokers who had not participated in the execution because

> it was not considered material. . . . [I]t was simply a matter of rewarding brokers for services furnished through the adviser, through the management, to the fund. Whether that was done directly through the give-up mechanism we did not consider a material item.

In response to a question by the court as to whether the shareholders were advised that it was not the Fund's practice to allow give-ups to Eberstadt, Zeller stated:

> No; [they] were not, your Honor, for the very reason . . . that the question was really whether any brokerage revenues flowed to the parent corporation, you see, and whether they flowed by any give-up or direct order was not considered either by us or our counsel to be sufficiently material to be put in the prospectus. You see, as long as we weren't getting brokerage, there was no disclosure problem. That was our judgment and the judgment of our lawyers. Had we gotten brokerage, then you would have had to disclose that.

Dr. Murray's testimony on disclosure to the shareholders was in substantial accord with that of Mr. Zeller.

In his opinion below, Judge Carter observed that

> while the full implications of the [brokerage] policy were not spelled out, the policy was announced to the shareholders in every *prospectus* issued since 1965 (emphasis added).[33]

399 F. Supp. at 953. He found that the January 27, 1972 proxy statement relating to the amendment of the certificate of incorporation and referring to recapture was not false and misleading. Though he apparently held that the disclosure provisions of the federal securities acts had not been violated by the earlier proxy statements, he did not specifically address himself to the question of whether the pre-1972 proxy statements (as opposed to prospectuses) omitted material facts.[34]

In *TSC Industries, Inc.* v. *Northway, Inc.*, —— U.S. ——, 48 L. Ed.2d 757 (1976), the Supreme Court formulated the

33 As previously noted, *supra*, n.15, the 1965 *prospectus* stated that brokerage was allocated partly on the basis of Fund shares sold and partly on services rendered. It also included the following passage which did not appear in proxy statements until 1969:

> [W]hile the Fund has never purchased or sold any securities through the firm of F. Eberstadt & Co. in the past, it may do so in the future but, if so, only in its capacity as broker with respect to transactions on a national securities exchange at regular exchange commissions and charges.

These statements were substantially repeated in the 1966, 1967, 1968, 1969, 1970, and 1971 prospectuses. The 1972 and 1973 prospectuses reflected the changes in the Fund's certificate of incorporation and in the permissibility of selecting brokers on the basis of sales. They also indicated that Eberstadt and M&D did not participate in the Fund's brokerage.

34 This may well have been because appellant's claims of inadequate disclosure to the shareholders, while raised below, were not framed as clearly as they have been on appeal and were not pressed by appellant as actively as her other claims of liability.

following test for determining the materiality of omissions in proxy statements:

> [A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills'* general description of materiality as a requirement that "the defect have a significant *propensity* to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[35]

Id. at 766 (footnote omitted). The Court went on to say that this ultimate determination of materiality requires

> delicate assessment of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact.

Id.

35 The Court, citing *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1301-02 (2d Cir. 1973), rejected the test of materiality ("all facts which a reasonable shareholder *might* consider important") applied in *Northway* by the Seventh Circuit as setting too low a threshold, and viewed as misplaced that court's reliance on *Mills* v. *Electric Auto-Lite Co.*, *supra*, as support for that broad definition of materiality.

As previously mentioned, at the annual meetings in the years 1966, 1970, 1971, 1972, and 1973, the shareholders were specifically asked to approve management agreements. During the entire period in question, moreover, the shareholders had the statutory right to terminate or renegotiate the current management contracts under section 15(a) of the Act, 15 U.S.C. §80a-15(a). In addition, there was an annual election of directors who had the power to continue existing management agreements without further shareholder approval unless the shareholders took affirmative action to terminate or renegotiate them.

During the years from 1965 to 1971, inclusive, the proxy statements issued to the shareholders made no reference to the fact that brokerage commissions were recapturable, the methods available to effect recapture, the board's periodic decisions to forego recapture, or the board's reasons for so deciding. While each of these proxy statements contained a description of the Fund's existing portfolio brokerage practices, the shareholders were not informed of the alternatives to these practices. Specifically, the 1966, 1967 and 1968 proxy statements, while stating the amount of brokerage allocated to promote sales and obtain additional research and statistical material and the intention to continue these practices, made no allusion to the alternative of recapture for the Fund's benefit by directing give-ups to Eberstadt or otherwise, the board's rejection of these alternatives, and its reasons for rejecting them. The addition in the 1969, 1970 and 1971 proxy statements of a reference to the Fund's intention not to do portfolio business through Eberstadt did not explain the significance of this fact or even mention that recapture for the benefit of the Fund was an available alternative.

The opportunity for recapture and the methods by which it could be accomplished bore directly on the management

agreement and what action the shareholders would take respecting it. The disclosure of the recapture alternatives was necessary in order for the shareholders to make an informed decision on whether or not to approve the new management contracts or whether or not to continue or renegotiate the current ones.

We have already held that the management and distribution agreements contemplated the allocation of brokerage by M&D to secure sales, additional research, and statistical services, and that the shareholders were informed of this in proxy statements. The shareholders should also have been informed that by approving these agreements they were foregoing an opportunity to effect recapture and thus lower advisory fees—even if, as mangement contends, such fees might eventually have to be adjusted to give M&D additional funds to secure the services needed to maintain the Fund's performance which would no longer be obtained by allocating brokerage.

We do not go so far as to hold that every possible alternative to a particular policy must be spelled out in a proxy statement. *See Doyle* v. *Milton*, 73 F. Supp. 281 (S.D.N.Y. 1947). We recognize that such a rule would indeed tend to defeat the purposes of the proxy rules by

> bury[ing] the shareholder in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.

TSC Industries, Inc. v. *Northway, Inc., supra,* at 765-66.

But, in our view, the same considerations of clear conflict of interest between the adviser and the Fund which required management to supply the independent directors with full information concerning the recapture question so that they could reach an informed judgment on the subject also mandated disclosure to the shareholders of the recapture alternatives and the board's decisions thereon.

Management recognized that the decision to forego available recapture opportunities was a significant and controversial one which involved substantial amounts of money. We have already seen the care taken to assure that this decision was legally permissible and the product of a carefully considered exercise of business judgment by a fully informed group of independent directors. We have also noted management's acknowledgment that the decision reached was "the closest kind of business decision." Yet, despite the repeated and extensive disclosures to the independent directors about recapture, the subject was never presented to the shareholders until 1972. This contravened the policy of the Investment Company Act as declared in its preamble,[36] rendered ineffectual the shareholders' approval of the management agreements, and deprived the shareholders of their right to terminate or seek renegotiation of the agreements under section 15(a)(3) of the Act, 15 U.S.C. §80-15(a)(3).

Under the circumstances here, disclosure of the fact that there were recapture opportunities which the Board had chosen to forego would have altered significantly the total mix of information available to a reasonable investor. There was a substantial likelihood that such disclosure would have assumed actual significance in a reasonable investor's deliberations concerning the management agreements. We view the omissions of any statements as to the recapture alternatives as "so obviously important to an investor, that reasonable minds cannot differ on the

36 15 U.S.C. §80a-1(b) provides:

> . . . it is declared that the national public interest and the interest of investors are adversely affected—
>
> (1) when investors . . . vote, refrain from voting . . . securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies . . . of such companies and their management. . . .

question of materiality." *TSC Industries, Inc.* v. *Northway, Inc., supra,* at 766, and find such omissions material as a matter of law.

The proxy statements for 1972, 1973 and 1974 are in a different posture. While it failed to detail the available recapture techniques and the board's prior consideration of the issue, the 1972 proxy statement raised the possibility of recapture in its discussion of the proposed amendment to the Fund's certificate of incorporation, and Judge Carter concluded that it was not false and misleading.

After viewing the facts omitted in the 1972 proxy statement against the disclosures that were made, *see TSC Industries, Inc.* v. *Northway, Inc., supra,* at 767-68, and giving appropriate weight to the assessments of the trier of the facts, *see TSC Industries, Inc.* v. *Northway, Inc., supra,* at 766, we cannot say that there was such a substantial likelihood that a reasonable shareholder would have considered these omissions either important in deciding how to vote or as so significantly altering the "total mix" of information available that the district judge's finding that they were not material was erroneous under *Northway.* We reach the same conclusion with respect to the 1973 and 1974 proxy statements, which came after the stockholders had been put on notice as to the possibility of recapture and approved the certificate amendment explicitly providing for board control over allocation of brokerage omissions.

We hold that the proxy statements for the annual meetings in the years 1967, 1968, 1969, 1970 and 1971 were false and misleading under rule 14a-9 because of the omission of material facts. *See Galfand* v. *Chestnutt Corp., supra; Gerstle* v. *Gamble-Skogmo, Inc., supra.* We therefore reverse the holding of the court below that the proxy statements for these years did not violate the disclosure pro-

visions of the federal securities laws. Responsibility for such omissions begins with the February 7, 1967 proxy statement since it is clear from the record that by then management and the independent directors had sufficient time to consider and react to the PPI report and make appropriate disclosures to the shareholders. *See Fogel* v. *Chestnutt, supra,* at 755, 755 n. 30; *Moses* v. *Burgin, supra,* at 385.

The case is remanded to the district court for determination of what damages, if any, were caused to the Fund by the proxy statements we have held to be in violation of rule 14a-9. *See Mills* v. *Auto-Lite Co., supra; Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975).

APPENDIX "C"

Opinion of Robert L. Carter, D.J. Dated July 29, 1975

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

OPINION

71 Civ. 2104

SUSAN TANNENBAUM,

Plaintiff,

—v.—

ROBERT G. ZELLER, et al.,

Defendants.

CARTER, J.:

I.

This is a derivative action brought pursuant to Section 44 of the Investment Company Act of 1940, as amended (15 U.S.C. § 80a-43); Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. § 78aa); and Section 22 of the Securities Act of 1933 (15 U.S.C. § 77v). Plaintiff who has been a shareholder of record of the Chemical Fund (Fund) continuously since at least 1965, sues on behalf of the Fund.

The latter, a Delaware corporation, is an open end "mutual fund" registered with the Securities and Exchange Commission under the Investment Company Act. The Fund's principal activity is its varied investments in the

chemical process industry. On December 31, 1965, the net total assets of the Fund were $433,849,751, and as of December 31, 1973, these assets had registered a more than 100% growth totaling $897,333,945. While the net total assets at the time of trial in 1974 were down to approximately 706 million dollars, a reflection of a general downward economic trend in this country, the Fund's performance still compared favorably with like investment operations.

The Fund's manager and distributor of shares pursuant to written contracts, is F. Eberstadt & Co., Managers & Distributors, Inc. (M & D), also a Delaware corporation. M & D is a subsidiary of F. Eberstadt & Co., Inc., a brokerage house founded by the late F. Eberstadt, who also served on the board of the Fund. M & D provides staff, offices, advice and recommendations to the Fund and manages and supervises the business and affairs of the Fund, subject to the latter's Board of Directors, a majority of whom are disinterested or unaffiliated directors; that is, having no association with F. Eberstadt & Co. or M & D, within the meaning of Sections 2(a)(3), 2(a)(19), 10(a) and 10(b), of the Investment Company Act, 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(19), 80a-10(a), and 80a-10(b). The management agreement and the distribution agreement obligate M & D to provide all statistical and research services at M & D's expense and to pay for the sale and distribution of Fund shares.

The unaffiliated or disinterested Fund directors are men of repute in academia, business and the professions. Among them are Dr. James S. Coles, director since 1968, currently President of Research Corporation, a foundation for the advancement of science, and before that President of Bowdoin College; Burt N. Dorsett, director since 1966,

currently Vice President and Senior Investment Officer for College Retirement Equities Fund, and former Vice President for Investments at the University of Rochester; Alfred E. Driscoll, director since 1957, currently Chairman of the New Jersey Turnpike Authority and former governor of New Jersey; Dr. Bertrand Fox, director since 1970, recently retired Professor of Investment Banking at Harvard University Graduate School of Business Administration; Dr. Roger F. Murray, director since 1959, Professor of Banking and Finance at the Columbia University Graduate School of Business, formerly Vice President, responsible for portfolio management at Bankers Trust Co., and at one time manager of the investment portfolio of the Teachers Insurance and Annuity Association & College Retirement Equities Fund; Whitman Hobbs, director since 1972, John N. Martin, Franz Schneider, long time director, and Julian Avery, director until 1968, holding responsible positions in various corporate business institutions; Dr. Howard Rusk, director since 1962, well-known authority on rehabilitation and other medical questions; Leroy Marek, director from 1959-1973, a consultant on scientific problems and issues; and James J. Minot, director from 1968-1970, senior partner in Paine, Webber, Jackson & Curtis, Inc.

The parent company, Eberstadt (formerly a partnership), until 1972 owned all the capital stock of M & D, and since that time has held 75% of M & D's stock. Eberstadt since 1962 has been a member of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) and continuously since 1970, a member or associate member of the American Stock Exchange (AMEX). Robert Zeller, the only individual defendant served, is Vice Chairman of the Fund's Board and of M & D's Board. Prior to the incorporation of Eberstadt, Zeller

was a partner in the firm. Since its incorporation he has been chairman of its Board and its chief executive officer.

Prior to 1971, the constitution and rules of the New York Stock Exchange required all members to charge at least a prescribed minimum commission on all transactions without regard to size or profitability. Moreover, the Exchange had always and continues to prohibit any direct rebate to a customer of any part of a commission earned by a member in the execution of a transaction, i.e., the consummation of a trade on the exchange. The costs of executing large orders, however, were not proportionately higher than the execution costs of small orders. But for the minimum commission regulation, broker-dealer firm members of NYSE in competing for business would have been willing to reduce their commissions based on quantity discounts to the customer. The unavailabilty of this form of discount led to a widespread practice in the mutual fund industry of customer directed "give-ups." Thus prior to December 5, 1968, it was common practice, custom and usage for a mutual fund through its manager to direct executing brokers on the NYSE and other national securities exchanges to "give-up" part of their commission to other exchange members who had no part in the execution of the transaction.[1] The "give-up" was normally directed to a non-executing broker but one who had sold the shares of the mutual fund to the public and/or who had provided useful research and statistical information.

[1] For a fuller explanation of "give-ups" and their *raison d'etre*, see *Fogel* v. *Chestnutt*, 383 F.Supp. 914, 916-919 (S.D.N.Y. 1974).

For the years 1965 through 1973, the Fund paid gross commissions to M & D, a portion of which M & D paid to non-affiliated dealers, in the amounts indicated below:

Year	*Sales Charge Received by M & D*	*Amt. Allowed To Dealers*	*Net Amt. Retained By M & D*
1965	$ 1,678,130	$1,443,784	$ 234,346
1966	2,126,476	1,676,727	449,749
1967	1,599,478	1,236,823	362,655
1968	1,440,831	1,118,046	322,785
1969	1,328,119	1,034,212	293,907
1970	2,098,752	1,619,762	478,990
1971	3,166,064	2,433,832	732,232
1972	6,334,902	4,885,042	1,479,860
1973	10,751,197	8,251,184	2,500,013

Between 1965 and 1973, the Fund paid brokerage commissions for the execution of purchases and sales of securities on behalf of the Fund on the NYSE, on which 80% of the portfolio transactions were executed, the AMEX and regional securities exchanges in the following amounts:

Year	*Amount*
1965	$ 339,860
1966	447,653
1967	617,787
1968	501,604
1969	472,757
1970	651,596
1971	920,767
1972	939,660
1973	1,291,735

From January 1, 1965 through December 5, 1968, brokers who executed transactions were directed by the Fund through M & D to "give-up" a portion of their commissions

to brokers and dealers who performed no services in the execution of these transactions. The "give-ups" were awarded to these non-executing brokers and dealers for services rendered in the selling of Fund shares and in providing statistical or research services without making any charge therefor. The "give-ups" constituted a substantial portion of the execution commission which, as previously suggested, executing brokers and dealers willingly shared because the low cost of execution was more than adequately met by the minimum commissions specified. These "give-ups" from 1965 to 1968 exceeded the following amounts:

Year	*Amount*
1965	$ 81,686
1966	136,200
1967	214,600
1968	246,600

From January 1, 1965, through July 15, 1973, one of the basis of which brokers and dealers were chosen as executing brokers or dealers to handle a portfolio transaction for the Fund was to reward them for the sale of Fund shares. During the years 1965-1970, commissions paid by the Fund when the sale of Fund's shares was a criterion for selection of an executing broker were as follows:

Year	*Amount*
1965	$ 271,910
1966	379,752
1967	510,346
1968	430,150
1969	363,036
1970	462,613

During that period and to date another basis for the selection of executing brokers was to compensate them for

providing statistical and research services to the Fund through M & D. The commissions paid in connection with such transactions were as follows:

Year	*Amount*
1965	$40,977
1966	42,900
1967	61,000
1968	45,967
1969	46,454
1970	91,662

These allocations are known as reciprocal brokerage, and approximately 98% of the Fund's portfolio transactions were allocated on this basis. After July 15, 1973, pursuant to a rule adopted by the NASD, the sale of Fund shares could no longer be a criterion for selection or non-selection of an executing broker or dealer.

While direct customer rebates were prohibited by the NYSE and AMEX and certain regional securities exchanges, a member firm serving as an investment advisor was not prohibited from crediting against its investment advisory fee some portion of the commission it earned from execution of portfolio transactions for the investment advisory client. Thus, M & D would have been permitted to credit against its management fee from the Fund some portion of any brokerage commission earned by Eberstadt in the execution of the Fund's portfolio transactions; and before "give-ups" were abolished, it would have been possible for Ebertstadt to have received "give-ups" from other member firms who acted as executing brokers for the Fund and for such "give-ups" to be credited against the Fund's management fee.

That fee, while based on a percentage lower than most in the industry, was not insubstantial as the management fees between 1965 and 1969 listed below indicate:

Year	*Amount*
1965	$1,160,563
1966	1,268,590
1967	1,428,228
1968	1,505,231
1969	1,521,868

On March 20, 1970, and on March 14, 1971, the formula for computation of the management fee was revised, and the fees in the years since have been as follows:

Year	*Amount*
1970	$1,662,203
1971	2,247,468
1972	3,097,640
1973	3,361,470

"Give-ups" were abolished by a rule of the NYSE effective December 5, 1968. Recapture of commissions or a portion thereof, however, was permissible in other respects until adoption of Article IX, Section 7(k) of the Constitution of the NYSE on January 29, 1973, and of the present Rule 318 of the NYSE on February 1, 1973. Similar rules have now been adopted by the AMEX and various regional exchanges.

The plaintiff's basic contention is that from January 1, 1965, until December 5, 1968, when "give-ups" were prohibited by NYSE rules, and up to the present when recapture of excess commissions was available, defendants were required to use the Fund-directed "give-ups" and the recapture of excess commissions for the benefit of the Fund;

that prior to December 14, 1970, the use of excess commissions to discharge M & D obligations under its management and distribution agreements with the Fund violated §§ 36 and 1(b)(2) of the Investment Company Act (15 U.S.C. §§ 80a-35 and 80a-1(b)(2)), entitling plaintiff to recover on behalf of the Fund; and that such use of excess commissions after December 15, 1970, violated §§ 36(a) and 1(b)(2) of the Investment Company Act (15 U.S.C. §§ 80a-35(a) and 80a-1(b)(2)), entitling plaintiff to recover damages on behalf of the Fund; and that such use from January 1, 1965, to the present constituted a breach of fiduciary duty at common law entitling plaintiff to recover damages on behalf of the Fund.

II.

Plaintiff's chief reliance is on *Moses* v. *Burgin,* 445 F.2d 369 (1st Cir.), *cert. denied sub nom. Johnson* v. *Moses,* 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971). Before proceeding further a few threshold observations may be helpful. Plaintiff may be correct in her view that the basic thrust of *Burgin* is that the management of a mutual fund is obligated to use all proper means to secure excess brokerage commissions for the benefit of the fund. However, application of that principle to this case will not necessarily result *a fortiori,* as plaintiff seems to suggest, in a conclusion that failure of M & D to direct "give-ups" or to recapture excess commissions through itself or Eberstadt violates the Investment Company Act or constitutes a breach of any common law obligation.

The facts in *Moses* v. *Burgin* are quite different from the facts developed in this case. As here, customer directed "give-ups" were paid over at management's behest to

brokers who sold Fund shares. The court held that there was a duty to recapture the excess commissions for the benefit of the Fund if freely available, and that the directors had no choice. The court found that the management company as a member of NASD could have joined various regional exchanges as a special member and could have become qualified to receive "give-ups" on those exchanges. 445 F.2d at 375. The court determined that the possibility of recapture through NASD or the regional exchanges was not disclosed to the unaffiliated directors, and that the management was under a duty to disclose all such information to the unaffiliated directors to permit them to decide what to do. Moreover, the court placed emphasis on a report of the Securities and Exchange Commission, Public Policy Implications of Investment Company Growth, H.R. Report, No. 2337, 89th Congress, 2d Sess. (1966) ("PPI"), issued one year before commencement of the litigation in *Burgin* in which it is stated, at p. 173, that "give-ups" should be directed to advisor underwriters for the purpose of applying those "give-ups" to reduce the advisory fees payable by the Fund. Also the court cited with confidence proposed Rule 10b-10 pursuant to which the SEC would require all excess commissions to be applied to a reduction of the advisory fee.

There is no evidence of non-disclosure by M & D to the unaffiliated directors in this case, and the SEC has fully retreated from its proposed Rule 10b-10 and at least in part from its unqualified position in the PPI report that "give-ups" be directed to reduction of advisory fees.

The *Burgin* formulation has not been adopted in this circuit. It has, of course, been discussed, *see Weiss* v. *Chalker,* 55 F.R.D. 168 (S.D.N.Y. 1972) and 59 F.R.D. 533

(S.D.N.Y. 1973); *Fogel* v. *Chestnutt,* 383 F.Supp. 914 (S.D. N.Y. 1974); *Frankel* v. *Hyde,* CCH Fed.Sec.L.Rep. ¶ 94,486 (S.D.N.Y. April 4, 1974); and *White* v. *Auerbach,* CCH Fed.Sec.L.Rep ¶ 93,617 (S.D.N.Y. September 19, 1972). Indeed, this court (Wyatt, J.) In *Fogel* v. *Chestnutt* finds *Burgin* unpersuasive.

Moreover, in view of the developments since *Burgin* one can be certain that whatever doubts might exist as to whether its basic thrust was non-disclosure, rather than a mandate that regional exchanges be utilized to secure "give-ups" for reduction of management fee, there is little doubt in my mind that non-disclosure is the only precedential value that *Burgin* now retains.

III.

In this case it is clear that F. Eberstadt from the very outset of the formation of the Fund took the position that his firm should not involve itself as executing broker for the Fund. The Board's consideration and discussion of the issue of "give-ups" and possibility of recapture were periodic and extensive. That discussion can be physicially documented beginning in 1967. M & D sent to the Board on January 9, 1967, a summary of the SEC PPI report. In its memorandum, M & D advised the Board that the SEC "looks with favor on the practice of using brokerage business on portfolio transactions to reduce" management costs, and indicated that brokerage affiliates of two mutual fund organizations had been recapturing commissions on the Pacific Stock Exchange. (Plaintiff's Ex. 74, pp. 6-7). Thus, the Board knew then that the current "give-up" practices could be utilized through Eberstadt to reduce management's fee.

On January 26, 1968, the SEC issued a release which dealt with the level and structure of commission rates on the NYSE, reciprocal brokerage and "give-ups." It considered the possibility of commissions being recaptured by the manager through give-ups or by earning the executing commission and applying the "give-ups" or commission to reduction of the fee. The release proposed adoption of Rule 10b-10 which would have allowed "give-ups" only if recaptured for the benefit of the Fund. The Board received copies of the release and on February 20, 1968, the Fund's counsel, Sullivan and Cromwell, advised the Board in an opinion letter stating in part "assuming that the Board of Directors has considered all the relevant facts . . . including the possibility of adopting alternate methods of handling the Fund's brokerage business whereby a portion of the commissions might be used to reduce the management fee, and assuming further that, as a result of such consideration, the Board of Directors has come to the conclusion as a matter of reasonable business judgment" that no change in its current practice be made, that such a course in its view would be lawful. (Plaintiff's Exhibit 75).

The next day, February 21, 1968, Dorsett & Murray, who made up the subcommittee to review the management and distribution agreements with M & D distributed their written report. The report referred to the SEC release and its discussion of the possibility of recapture of commissions through "give-ups" and management receipt of commissions, proposed Rule 10b-10, and the opinion letter of counsel. The report pointed out that the Fund had paid $618,000 in brokerage commissions in 1967; that some $510,000 of this had been allocated to brokers based on volume of Fund shares sold; that it was a practice of the Fund with full knowledge of the Board and shareholders

to use the allocation of brokerage business and Fund-directed "give-ups" "as additional compensation to dealers who sell Fund shares." It advised no change in the Fund's method of doing business "even though we recognize [the possibility of requesting the manager to act as executing broker or to] request give-ups on portfolio transactions which would be credited against the . . . management fee." (Plaintiff's Ex. 76). That same day the Board met, discussed the report, and voted to continue the existing arrangements.

On February 19, 1969, the same subcommittee in its review of the operation of the Fund and the management and distribution agreements filed a written report. The report noted that the subcommittee had again reviewed the basis on which brokerage commissions were allocated and recommended no change. It noted the abolition of "give-ups" as of December 5, 1968, by the NYSE. It recommended continuation of the practice of not using Eberstadt as executing broker even though recognizing that M & D could be requested to use Eberstadt in this capacity. (Plaintiff's Ex. 120). This report was discussed by the Board and it voted to continue existing arrangements.

The subcommittee report of January 22, 1970 (Plaintiff's Ex. 121) again reviewed and recommended continuation of the current practice of allocation of brokerage business and the policy of not using Eberstadt as executing broker. It recommended that the only restriction on the complete discretion of M & D in the allocation of brokerage commissions be that no change in the policy of not using Eberstadt as executing broker be made "without the specific concurrence of a majority of the unaffiliated directors". This report was distributed to the directors, and on Febru-

ary 18, 1970, the Board voted to continue its existing practice as to brokerage commissions.

In 1971, the subcommittee report was made by Dr. Murray and Governor Alfred Driscoll and again the subcommittee reviewed the brokerage allocation and the possibility of recapture and concluded it would be inadvisable to alter present arrangements. (Plaintiff's Ex. 122). Again the full Board concurred.

Copies of the decision relied on by plaintiffs here, *Moses* v. *Burgin*, were mailed to the Fund's directors on June 4, 1971. At the June 16, 1971, Board meeting a committee consisting of Dr. Murray, Governor Driscoll and Dr. Bertrand Fox, all unaffiliated directors, was appointed to review again the issue of the Fund's brokerage allocations and various alternatives. After consultation with counsel, the committee recommended no change. At the Board of Directors meeting of December 15, 1971, M & D reported that brokerage affiliates of other mutual funds had been utilizing regional securities exchanges to recapture brokerage commissions and had been applying them to reduction of management fees, and that SEC was expected to announce a position on the question soon. On March 27, 1972, and on January 15, 1973, the subcommittee after review of policy recommended no change. (Plaintiff's Ex. 123, 124). On January 14, 1974, the audit committee consisting of Governor Driscoll, and Messrs. Hobbs and Richard recommended adherence to existing policy. (Plaintiff's Ex. 78).

On the basis of this record, it is clear over the years that the Board's unaffiliated directors have given careful consideration to the issues raised by the plaintiff. The Board has examined the practices each year, noted what

methods were available for the Fund to recapture excess brokerage commissions but each time has concluded that it should not do so.

On March 14, 1972, the articles of incorporation were amended to make specific that the Board had power "to determine . . . the manner and purposes of the allocation of brokerage commissions to be paid by the Fund." In the notice of annual meeting [2] distributed in connection with the March 14, 1972, shareholders meeting, it was stated in respect of the proposed amendment to the articles of incorporation that the Board felt it to be in the best interest of the Fund to continue the practice of having all portfolio transactions carried out by brokers not affiliated with Eberstadt and of not making any provision for recapture of commissions through affiliated brokers. The statement also said that the Board had directed the manager not to use Eberstadt as executing broker. (Plaintiff's Ex. 35, p. 6).

The notice of meeting stated that this law suit had been instituted and that it "challenged the brokerage practices and the reasonableness of the management fees • • • [and] seeks injunctive relief and damages for the benefit of the Fund." (*Id.* at p. 10). The amendment was approved on March 14, 1972.

The plaintiff contends that from January 1, 1965 to date, each of the Fund's notice of annual meeting (Plaintiff's Ex.

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[2] Plaintiff actually alleges that the proxy statement was false and misleading. No proxy statement was made a part of the record. In support of this allegation and succeeding references to proxy statements, plaintiff cited her Exhibits 28-38, which are the various notices of annual meetings from 1965 to date which enclosed the proxy for the year in question. The opinion, therefore, refers to these notices and modifies the plaintiff's contentions as claiming these notices violated the law.

28-38), Form N-1R and Form N-1Q reports (Plaintiff's Ex. 39-54; 88, 125-127) and prospectuses were materially false and misleading in failing to disclose: that "give-ups" and "reciprocals" were being used to discharge contractual obligations which M & D owed to the Fund under the management and distribution agreements; that the Fund was receiving less than net asset value because excess brokerage commissions were not being used to reduce management and distribution fees, and that prior to December 5, 1968, "give-ups" went to brokers who had no part in execution of portfolio transactions. However, the uncontroverted facts are that during this period, the unaffiliated directors were advised and kept fully abreast of their power if they wished to change existing policy, and of the SEC views and proposals on the issues. The Board voted no change and took full responsibility for the continuation of its policy of not using Eberstadt as executing broker.

Moreover, while the full implications of the policy were not spelled out, the policy was announced to the shareholders in every prospectus issued since 1965. During this period the shareholders have been informed of the Fund's policy of brokerage allocations and of not utilizing Eberstadt in this connection. Its 1965 prospectus stated that the manager places orders for purchase and sale of securities "with dealers where it believes the best execution can be obtained," and that allocation of brokerage business of the Fund was made "partly on the basis of the Fund shares sold and partly on the basis of services rendered." It also stated that the Fund had never utilized F. Eberstadt & Co. as an execution broker but that it might do so in the future but "if so, only in its capacity as broker in respect to transactions on a national securities exchange at regular exchange commissions and charges." (Plaintiff's Ex. 11).

The 1966 prospectus set forth the total brokerage fees paid by the Fund in 1965, indicated how much of that went to dealers based on Fund shares, and how much to dealers for providing statistical research and other services to the manager. It further stated that "these services do not reduce the expenses of the [m]anager by a material amount"; that the Fund currently intended to continue the same policy of allocation. The statement in the 1965 prospectus in respect of non-utilization of Eberstadt as execution broker was repeated (Plaintiff's Ex. 12). In 1967, 1968, 1969, 1970 and 1971, similar statements indicating how brokerage business was allocated and the same litany as to non-utilization of Eberstadt as an executing broker were repeated in the prospectuses (Plaintiff's Ex. 13, 14, 15, 16 and 17).

The 1972 prospectus changed this statement somewhat because policy had changed. It sets forth the total brokerage fees paid during 1971, indicating that 67% of such fees had been allocated to brokers who sold Fund shares and provided research and statistical information, 20% to those who sold shares but supplied no additional services, and 11% to brokers who provided only statistical and research information. As to all it was said that the brokers had supplied the best execution. It was stated that the Board had directed management not to use Eberstadt as execution broker, and reference was made to SEC's policy statement of February 2, 1972, indicating that reciprocal brokerage as a reward for selling shares should be terminated. (Plaintiff's Ex. 18, p. 10).

The 1973 prospectus stated that selection of brokers "is made strictly on the basis of the value and quality of the brokerage services rendered," set forth the total brokerage commissions paid and as usual asserted that Eberstadt did

not participate in the Fund's brokerage business. (Plaintiff's Ex. 19, p. 8).

Plaintiff alleges that the Fund's January 27, 1972, notice of annual meeting was false and misleading. This statement was distributed in connection with a shareholders' meeting of March 14, 1972, convened to vote on the proposed amendment to the Fund's certificate of incorporation authorizing the Fund's Board "to determine in their discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund." The notice represented that the purpose of the amendment was to "make explicit that which has always been implicit" that power to determine how the Fund's portfolio is used rests with the Board. This statement is alleged to be false because "*Moses* v. *Burgis* squarely held that directors of the fund lacked that power," and because the real purpose of the amendment was an effort to circumvent *Burgis*. (Plaintiff's Post-Trial Brief). Suffice it to say that, as already indicated, *Burgis* for me is clear authority only for the proposition that management in failing to disclose to non-affiliated directors all facts pertinent to their determination of Fund policy acts at its peril.

IV.

[1, 2] The issue raised here concerns a problem that has long troubled the securities industry. Mutual funds are organized by brokerage firms which become investment advisors to the fund. The fund is a shell, and the advisor provides office space, staff and management services. The advisor or manager decides on investments and acts as disributor or underwriter for the sale of fund shares. Its function and compensation are determined by contract. It is argued by management that sales must be continuous so

that the fund will have on hand sufficient cash to redeem shares. Since the management fee is tied to the size of the fund, it is usually to management's benefit to encourage sales. In 1966, the Securities and Exchange Commission's report, PPI at 203, showed that redemptions constituted a minor percentage of the Fund's assets. The figure ranged from a low of 3.9% in 1958 to a high of 6.4% in 1964; in 1965 the percentage was 5.6%. *Ibid.*

It was early recognized that mutual fund operation creates numerous conflicts of interest when a manager acts as advisor and distributor. These conflicts occur because the opportunity for self-dealing is great. But these hazards indigenous to mutual funds do not appear to be the problems raised in this litigation. The market performance of the Chemical Fund has been consistently above average when measured against the performance of other funds with similar investment programs and against the performance of the market in general. For example, between December 30, 1968, and November 14, 1974, Dow Jones Industrials registered a 31.5% loss, Standard & Poor's 425 showed a 28.9% loss, while Chemical Fund registered a 0.8% loss. Using the period September 30, 1971, to November 15, 1974, as a basis for comparison, the Fund evidenced the best market performance of some 14 comparable mutual funds, and did better than the general market as evidenced by Dow Jones Industrials and Standard & Poor's 425. When the period December 31, 1973, to November 15, 1974, is used, the Fund again ranks better in terms of performance in general as evidenced by Dow Jones Industrials or Standard & Poor's 425 and ranked sixth in respect of comparable funds. Exhibits showing expenses per dollar of assets for the years 1969-1970 (Plaintiff's Ex. 93-97, Schedule A) demonstrate that the Fund again compares favorably with other

comparable mutual funds. Moreover, it is also established that churning is not an issue, since the brokerage commissions paid by the Fund are below that of the industry as a whole. The parties have stipulated that since prior to 1965, in selecting brokers for the execution of the Fund's portfolio transactions, management's primary concern has been at all times "the price and quality of the execution to be provided to the Fund" (Pretrial order ¶ XXII). We have here, therefore, no issue of a manager engaging in any transactions for personal profit, apart from the management fee. *Cf. SEC* v. *Capital Gains Research Bureau Inc.*, 375 U.S. 180, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963).

When *Moses* v. *Burgin* was decided, fixed commissions and prohibition against direct customer rebates were the practice. The institutional funds engaged in huge transactions but quantity discounts were not permitted. Brokerage commissions were far in excess of the costs and reasonable profit on the transaction. Thus "give-ups" came into being. Managers of mutual funds used "give-ups" to reward brokers for statistical and research services. Plaintiff contends that paying others for such services was unwarranted since the contract with the manager required M & D to provide these services at its own expense. Defendants contend that M & D used the research services of others to test the soundness of its own information. But these practices were done with the unaffiliated directors having all the facts and specifically approving the practice and with full disclosure to shareholders. Since the fundamental purpose of the federal securities laws is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry," *SEC* v. *Capital Gains, supra*, at 186, 84 S.Ct. at 280, it cannot be said that

any violation has been disclosed on this record. (Emphasis in the original).

What is involved here is the exercise of a good faith business judgment. On the facts developed before me, I have no basis for finding that the Board failed to exercise such care and diligence in respect of the matters in controversy that careful and prudent men could reasonably be expected to exercise under similar circumstances. *See Ballentine on Corporations,* § 63 (Rev.Ed. (1946)). When questions arose the Board sought and relied upon the advice of counsel which alone is sufficient to free them of liability. *See Spirt* v. *Bechtel,* 232 F.2d 241, 247 (2d Cir. 1956). Nor has any fiduciary obligations of management been breached. The policy of the Board and of Eberstadt from the outset was to seek to keep conflicts of interest in respect of M & D as manager and adviser of the Fund and M & D as an Eberstadt subsidiary to a minimum. This poses a real problem in the mutual fund field, *see Comment,* Duke L.J. 429, 432 (1972); *Note,* 68 Colum.L.Rev. 334 (1968); Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds,* 115 U. of Pa.L.Rev. 1058 (1967).

That what is involved here is not an infraction of federal law but policy and an exercise of judgment is made clear in the February 2, 1972, Special Report by the SEC on the Future Structure of the Securities Market, 137, Part II, Bureau of National Affairs, at page 6:

> "[w]hile the Commission is concerned that the level of commissions be reasonable in all transactions . . . obtaining the best brokerage services, not merely the amount of the commission must be the ultimate criterion."

Continuing at page 7, the report describes investment research as "a fundamental element of the brokerage function for which bona fide expenditure of the beneficiary's funds is completely appropriate." The report discusses three types of institutional membership on securities exchanges. Membership on an exchange to be used primarily as a vehicle for recapture of commissions was specifically condemned. It discussed the question of exchange members engaged primarily in public brokerage but also engaged in money management and performing brokerage for the accounts it manages. It did not condemn the practice of a fund whose manager is affiliated with a broker-dealer who does business with the public and also executes some transactions for the affiliate. The Commission did not condemn this practice, because where the broker-dealer was directly managing and advising, it could carry out transactions for these accounts and the public (pp. 8-9). Commissioner Owens dissented from this portion of the report. *Id.* at p. 10. He would prohibit institutions doing business through a broker-dealer it controls and broker-dealers from doing portfolio brokerage for accounts it manages—the very policy which the Fund's Board has adopted. *See* Miller & Carlson, *Recapture of Brokerage Commissions By Mutual Funds,* 46 NYU L.Rev. 35 (1971).

The unaffiliated directors placed a higher value on having the Fund's portfolio transactions free from any taint of self-dealing by Eberstadt; avoiding an appearance that securities in which Eberstadt has a position were being pushed and in attempting to make certain in appearance and in fact that the investments the Fund makes were based on objective good faith and not self-interest of the brokerage firm with which it is affiliated.

A recent amendment, Section 6, Securities Acts Amendments of 1975 (Pub.L. 94-29), to the securities law would appear now to bar Eberstadt from any involvement in the portfolio transactions of the Fund. The plaintiff properly points out that the new amendment applies only after May 1, 1978, and does not affect defendants' liability prior thereto. This, of course, is true. *Moses* v. *Burgin,* viewed in the light of the amendment and the modification in SEC approach between 1966 and the present to the question raised here, must be interpreted to accord with decisions holding that a requirement of full disclosure and lack of misrepresentation encapsulates the impact of the federal securities laws. Moreover, the new law undergirds the flooring on which the court's view is based that the Fund policy under attack is clearly an exercise of sound business judgment and outside the reach of the jurisdiction of this court. In summary, I find no basis for liability under either the federal securities law or the common law. Accordingly, judgment is ordered for the defendant.

The above constitutes the court's findings of fact and conclusions of law pursuant to Rule 52(a), F.R.Civ.P.

So ordered.

Supreme Court, U. S.
FILED
SEP 29 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-332

F. EBERSTADT & CO. INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC. and ROBERT G. ZELLER,

Petitioners,

vs.

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-332

F. EBERSTADT & CO. INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC. and ROBERT G. ZELLER,

Petitioners,

vs.

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

Respondent Susan Tannenbaum submits this brief (a) in opposition to the petition for a writ of certiorari herein to the United States Court of Appeals for the Second Circuit and (b) in response to the brief of the Investment Company Institute as *amicus curiae* in support of the petition.

Questions Presented

1. Did the proxy statements issued to shareholders of Chemical Fund, Inc., for the annual meetings in the years 1967 through 1971 fail to disclose material facts in violation of the proxy rules promulgated by the Securities and Exchange Commission pursuant to the Investment Company Act of 1940?

2. Was the non-disclosure issue fairly presented in the District Court?

Statutes Involved

In addition to the statutes and rules reproduced in the petition, there is involved Section 15(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-15(a), which is reproduced in the appendix to this brief.

Statement of the Case

This stockholders' derivative action was commenced in May 1971 by respondent Susan Tannenbaum on behalf of respondent Chemical Fund, Inc., a registered investment company (mutual fund). The action had its genesis in portfolio brokerage practices which were common to the mutual fund industry during the 1960's, prior to the advent of negotiated commission rates on the nation's securities exchanges. Plaintiff sought damages on behalf of the Fund against petitioners (the manager of the Fund and certain controlling persons) by reason of:

> (1) petitioners' failure to cause the Fund to recapture portfolio brokerage commissions for the benefit of the Fund; and

> (2) the failure to disclose material aspects of the Fund's brokerage practices in proxy statements and other documents issued to Fund shareholders.

The action was tried without a jury in the District Court solely on the question of liability. On August 1, 1975, the District Court entered judgment dismissing the action.

On appeal, the Court of Appeals rejected plaintiff's contentions (a) that the Fund's manager and interested directors had a duty to recapture excess commissions for the Fund's benefit under the Fund's charter and its management and distribution agreements; (b) that the failure to recapture violated Section 36 of the Investment Company Act, 15 U.S.C. § 80a-35, and (c) that the manager and interested directors had violated their duty of disclosure to the independent directors.

The Court of Appeals concluded, however, that the proxy statements distributed to the Fund's shareholders for the years 1967 through 1971 violated the disclosure provisions of the federal securities laws, because they failed, among other things, to advise the shareholders, who had an express statutory right under Section 15(a) of the Investment Company Act to approve, terminate or renegotiate the Fund's management contract: (a) that substantial portions of the Fund's brokerage commissions were recapturable for the Fund's benefit and (b) that the Fund's board—for reasons never disclosed—had decided to forego recapture (A70-71).*

The Court of Appeals remanded the action to the District Court to determine what damages, if any, were

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* References preceded by "A" are to the appendix to the petition which contains the opinions of the Court of Appeals and of the District Court.

caused to the Fund by the proxy statements found to be in violation of the proxy rules (A74).

In seeking rehearing in the Court of Appeals, petitioners did not urge that that court had overlooked or misapprehended any controlling point of law or issue of fact, nor did they suggest that the issue for which they sought rehearing had not been thoroughly briefed and argued on appeal. The focus of their petition was, in fact, decidedly away from the merits of the issue on which plaintiff had prevailed—namely, the adequacy of the disclosure in the Fund's proxy statements during the years 1967 through 1971. They relied instead on a presumed "disaster for the mutual fund industry" which, it was claimed, would result from the court's decision and on alleged procedural infirmities in the District Court. The same points are again pressed here.

Reasons for Denying the Writ

The reasons urged by petitioners in support of the writ are, we submit, misleading and incomplete. Neither the petition nor the amicus brief directly addresses itself to the cogent analysis found in the opinion of the Court of Appeals regarding the adequacy of disclosure in the Fund's proxy statements during the years 1967 through 1971 (A61-74). Applying the test formulated by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 96 S. Ct. 2126 (1976), for determining the materiality of omissions in proxy statements, the Court of Appeals found that the omissions regarding the availability of, and the decision to forego, recapture were material as a matter of law (A72-73).

Petitioners do not attack the consistency or logic of the Court of Appeals' reasoning, nor do they point to any

overlooked or misapprehended precedent. The thrust of their argument is that the Court of Appeals should have been more alert to the "policy implications" of its decision (petition, p. 11)—considerations which, in our view, should more properly be raised in a legislative forum. We nonetheless respond briefly to the contentions made in support of the petition.

A. The contention that the Court of Appeals' decision "spells disaster" for the mutual fund industry.

Petitioners urge at page 9 of the petition that, if the decision below stands, "most mutual fund proxy statements in recent years will be deemed false and misleading, most mutual fund management contracts are in limbo and mutual fund managers and directors stand exposed to liability . . ." We find it difficult to respond to these contentions, because they are addressed to matters wholly outside the record in this case, are supported by factual assertions that seem to be dubious at best and, in any event, are irrelevant.

First, because of the advent of negotiated brokerage rates, recapture no longer has the significance for mutual funds that it once had.* Through competition and negotiation, "excess" commission dollars have been eliminated,

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* In its brief *amicus curiae* in support of rehearing in the court below the Investment Company Institute (ICI) stated (pp. 9-10):

> "Due to the establishment of competitive rates of brokerage commissions, mutual funds basically are no longer faced with the decision of whether to recapture. *Thus, the recapture issue has for practical purposes become moot and the Court's requirement of the disclosure at issue will not be a guide to future conduct.*" (Emphasis added.)

(Footnote continued on following page)

and commission charges have been driven down to the point that recapture is not practicable. Furthermore, most avenues of recapture have been closed off in recent years, first through administrative action and later by legislation. In February 1972 the SEC issued its Policy Statement on the Future Structure of the Securities Markets. The SEC, having forced the abolition of give-ups in December 1968, stated in its report that reciprocal practices must also be terminated. In response, the NASD proposed in 1972 a rule to abolish reciprocals, which became effective in July 1973. In 1973, the SEC promulgated Rule 19b-2, which greatly circumscribed the ability of mutual funds to obtain reductions of commissions through institutional membership on the exchanges. These developments were capped by the adoption of the Securities Acts Amendments of 1975, which eliminated transactions for one's own account or that of an associate. *See Fogel* v. *Chestnutt,* 533 F.2d 731, 740-744 (2d Cir. 1975), cert. denied, 429 U.S. 824, 97 S. Ct. 77 (1976). Pursuant to Rule 19b-3, effective May 1, 1975, fixed commission rates were prohibited.

The virtual elimination of recapture over the last several years makes somewhat puzzling the notion that the Court of Appeals' decision, if permitted to stand, "spells disaster" for the mutual fund industry (petition, p. 8) or will "stimulate a new wave of derivative mutual fund litigation" (petition, p. 9). If, as the ICI asserted in its brief in the Court of Appeals (see footnote, p. 5, *supra*), recapture is no longer a viable technique (in stark con-

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(Footnote continued from preceding page)

Elsewhere in its brief the ICI described recapture as being ". . . obsolete in light of the advent of competitive brokerage rates" (p. 2) and a "no longer relevant practice" (p. 9). All references to the fact that the issue of recapture is now moot have been deleted from its brief in this Court.

trast to the situation that prevailed in the industry prior to 1972), there could hardly have been a disclosure issue in the last several years so far as a fund's proxy statements were concerned. The alleged impact of the decision below on fund management contracts is, we submit, chimerical.

Although the ICI states in its brief (p. 13) that a "new round of litigation could be triggered" by the decision of the Court of Appeals, we do not know of any other lawsuit, initiated before or since that decision, which alleges proxy violations relating to recapture; nor have petitioners or the ICI pointed to any such case.

The suggestion that the decision below will subject members of the industry to horrendous damage claims is equally unsound. Commencing with the landmark *Moses* v. *Burgin* decision in June 1971*, mutual funds *did* begin to disclose in their proxy statements (a) the possibility of recapture and (b) the determination of the fund's board with respect to recapture. (Indeed, as explained at length in the decision below (A64-66), that is precisely what occurred in the case of Chemical Fund, starting with its 1972 proxy statement.) Although the amicus asserts (p. 6) that to "the extent we have been able to determine", fund proxy statements generally did not contain these disclosures, its brief is significantly vague as to date. The absence of such disclosures in current proxy statements undoubtedly reflects the fact that recapture is no longer a viable alternative.** The absence of such disclosures in proxy statements issued prior to the *Moses* decision is

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* *Moses* v. *Burgin,* 445 F.2d 369 (1st Cir. 1971), cert. denied sub. nom. *Johnson* v. *Moses,* 404 U.S. 994, 92 S. Ct. 532 (1971).

** See footnote, p. 5, *supra.*

also not surprising, since it was evidently not the practice (as shown by *Moses, Fogel* and settlements achieved in a substantial number of similar lawsuits) for fund managers to bring to the attention of the independent directors (much less, the shareholders) the fact that recapture of commissions for the fund's benefit was a distinct possibility. We think it extremely unlikely, however, that sophisticated fund managers, confronted with the clear threat of litigation following the *Moses* decision, did not fully disclose in proxy statements the policy of the fund with respect to recapture so long as that technique remained viable. In short, the potential for new litigation arising from the Court of Appeals' decision (if it exists at all) is in all probability limited to proxy statements issued in 1971 and prior years and circumscribed by applicable statutes of limitations.

Some comment also seems appropriate on the applicable measure of damages in cases where, as here, fund proxy statements are found not to have made proper disclosures. While we take no position at this time regarding the appropriate measure of damages,* the suggestion that the manager might be required to pay the Fund damages in an amount equal to the entire management fee seems somewhat fanciful. In *Lutz* v. *Boas,* 171 A.2d 381 (Del. Ch. 1961), Chancellor Seitz, confronted with the same issue, rejected the argument that the defendants should be compelled to repay the entire management fee and adopted a measure of recovery based on equitable principles.

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* As the Court of Appeals noted in its decision (A7), the action was tried in the District Court on the issue of liability only. In remanding to the District Court, the court expressly left open the issue of damages (A74).

B. The contention that the SEC "rejected" in 1972 any requirement that the possibility of recapture be disclosed.

Both the petition and the amicus brief place heavy emphasis on the notion that the SEC "rejected" any requirement that fund proxy statements disclose the possibility of recapture for the benefit of the fund when it adopted new guidelines for the preparation of fund prospectuses in 1972. In doing so, they:

(a) ignore the fact that both the proposed 1969 guidelines (Release No. 40-5634) and the 1972 guidelines (Release No. 40-7220) are directed only to prospectuses, not proxy statements;

(b) ignore the fact that prospective purchasers of fund shares (as opposed to existing shareholders) are not authorized, or asked, to approve or reject the fund's management contract and by implication the fund's policy toward recapture;

(c) ignore the fact that the 1969 guidelines were proposed in light of portfolio practices that were tolerated at the time but, as a result of the *Moses* decision and the changing attitude of the SEC, had largely been proscribed by the time the 1972 guidelines were issued;

(d) ignore the following statement in the 1972 guidelines (p. 2):

> ". . . the public is cautioned that the opinions expressed in this release are not, and do not purport to be, an official expression of the Commission's views."

In short, the change in the guidelines for fund prospectuses from 1969 to 1972 hardly constitutes an authoritative declaration by the Commission that a fund need not disclose in its proxy statement, when asking shareholders to consider and vote on the management contract, the fact that management has considered and rejected recapture.

Similarly, we think that the petition and amicus brief vastly overstate the significance of the fact that the Fund's proxy statements, like those of all other mutual funds, were routinely filed with the SEC. As noted in the decision below (A18-19), the SEC was admittedly less than consistent in its approach to recapture and the overriding problem of excess commissions. In light of the SEC's own uncertainty, it is not surprising that it did not promulgate rules or policies setting forth the precise kinds of disclosures required in fund proxy statements in all circumstances. In any event, under Section 15(a) of the Investment Company Act, the shareholders of a fund have been given significant voting powers with respect to the approval or rejection of the fund's management contract. That being so, the conclusion is inescapable that the shareholders are entitled to full disclosure of every material fact bearing on the matter under consideration, irrespective of the directors' views regarding the merits of the proposal.

C. The contention that the disclosure issue was not raised in the District Court.

Petitioners urge in their petition, as they earlier urged in the court below, that the question of the adequacy of disclosure in the Fund's proxy statements, annual and quarterly reports and prospectuses was not properly raised in the District Court. The Court of Appeals acknowledged in its opinion that such an argument had been made but rejected it (A68, fn. 34), and the same argument was rejected on petition for rehearing.*

Petitioners again make the argument that plaintiff's disclosure claims were "mere after-thoughts". We repeat our earlier rejoinder: Although neither the complaint nor the pre-trial order specifically spells out plaintiff's non-disclosure claims, they are integrally related to plaintiff's other claims; the proxy statements relied on (Exhibits 28-38) were introduced in evidence at the trial without any objection by defendants' counsel (Tr. 10-11); defense witnesses were questioned about the disclosures in those documents (Tr. 135-138, 196-199); the issues were briefed before the District Court; and the District Court specifically dealt with those issues in its opinion (A89-90).**

Additional argument is made in support of the writ on the ground that plaintiff's counsel (a) did not focus the trial court's attention on the disclosure issue in his opening statement and (b) asked only one question of defendants' witnesses regarding the disclosures (petition, p. 5).

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* In its brief *amicus curiae* in the Court of Appeals the SEC stated (p. 20, fn. 24):

> "We likewise take no position with regard to the claims *arising under the securities laws and based upon the lack of adequate disclosure of the Fund's brokerage practices to the shareholders.* This issue is primarily an evidentiary question as to the correctness of the district court's finding that that disclosure was adequate." (Emphasis added.)

** Under Rule 15(b), F.R.C.P., the District Court is authorized to conform the pleadings to the issues raised and evidence presented at the trial even after judgment.

It is respectfully submitted that all of the Fund documents in question, namely, the proxy statements and other documents issued to Fund shareholders, speak eloquently for themselves. All of these documents—prior to 1972*—are silent on the availability of recapture for the Fund's benefit, the substantial sums that could be recaptured and the decision of the Board to forego recapture. From plaintiff's perspective, little purpose would have been served at trial in asking defendants' witnesses for elaboration of the documents, and plaintiff's counsel chose not to do so. Defendants' counsel adopted the same course. More significantly, however, petitioners fail to suggest in their petition how the patent deficiencies of those documents could be remedied by any evidence introduced at a new trial.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Dated: New York, New York
September 29, 1977

Respectfully submitted,

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* The Fund's 1971 proxy statement is dated March 31, 1971. This action was commenced on May 11, 1971. The *Moses* opinion was handed down on June 23, 1971.

APPENDIX

*Section 15(a) of the Investment Company Act, 15 U.S.C. § 80a-15(a)**:

> (a) After one year from the effective date of this subchapter, it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—
>
> (1) precisely describes all compensation to be paid thereunder;
>
> (2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;
>
> (3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such regis-

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* In effect prior to December 14, 1971. Section 15(a) was amended in several respects by Pub. L. 91-547, § 8, 84 Stat. 1419, which was enacted on December 14, 1970. Pursuant to Pub. L. 91-547, § 30, the amendments became effective on December 14, 1971. None of the amendments are germane to this action.

tered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

MOTION FILED
SEP 19 1977

In the

Supreme Court of the United States

October Term, 1977

No. 77-332

F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert G. Zeller,

Petitioners,

—against—

Susan Tannenbaum and Chemical Fund, Inc.,

Respondents.

MOTION OF INVESTMENT COMPANY INSTITUTE FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE* AND BRIEF IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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Rule 20a under the 1940 Act, 17 Code Fed. Reg. § 270.20a 10, 10n

SEC Releases:

Release No. 40-5634 (1969) 5n

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Release No. 34-13388 (1977) 12n

Other Authorities:

S.Rep. No. 91-184, 91st Cong., 2nd Sess. (1970) 7n

3 U.S. Cong. & Adm. News, 91st Cong., 2d Sess. at 4901 (1970) 7n

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-332

F. EBERSTADT & CO., INC., F. EBERSTADT & CO., MANAGERS AND DISTRIBUTORS, INC., and ROBERT G. ZELLER,

Petitioners,

—against—

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

MOTION OF INVESTMENT COMPANY INSTITUTE FOR LEAVE TO FILE A BRIEF AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

Pursuant to Rule 42 of the Rules of the Supreme Court of the United States, the Investment Company Institute (I.C.I.) moves for leave to file a brief as *amicus curiae* in support of the petition for a writ of certiorari of F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert Zeller. This motion is necessary because the Respondent Susan Tannenbaum refused to consent to the filing of an *amicus curiae* brief by the I.C.I.

The I.C.I. is the national trade association of open-end investment companies ("mutual funds"), their advisers and underwriters. The mutual fund members of the I.C.I. have about 7.5 million shareholders and assets of about $43 billion, representing over 90% of the assets of the domestic mutual fund industry. The I.C.I. is generally recognized as the spokesman for the mutual fund industry to the public and to the government.

The March 4, 1977 decision of the Second Circuit Court of Appeals in this litigation held that a mutual fund was required to disclose in its proxy statements what the Court determined to have been a reasonable business judgment of its Board of Directors to forego the possibility of recapture of "excess" brokerage commissions. This type of disclosure has never been required by the Securities and Exchange Commission, is inconsistent with industry and administrative understanding and practice, is inconsistent with the reliance placed on the independent directors by the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq., and will not provide relevant information to shareholders of a mutual fund.

The I.C.I. wishes to point out to the Court the adverse consequences which the Second Circuit's decision is likely to have upon the mutual fund industry and also upon other corporations which are subject to the disclosure requirements of the federal securities laws. The I.C.I. therefore respectfully prays that the Court grant this motion for leave to file its brief in support of the petition.

September 16, 1977

Respectfully submitted,

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Petitioners,

—against—

SUSAN TANNENBAUM and CHEMICAL FUND, INC.,

Respondents.

BRIEF OF INVESTMENT COMPANY INSTITUTE, *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

This brief is submitted on behalf of the Investment Company Institute ("I.C.I.") as *amicus curiae* in support of the petition for a writ of certiorari filed by F. Eberstadt & Co., Inc., F. Eberstadt & Co., Managers and Distributors, Inc., and Robert G. Zeller (the "Petitioners"). The principle of disclosure advocated by the decision rendered against the Petitioners is important and generally applies to the mutual fund industry and also to all other corporations which are subject to the disclosure requirements of the federal securities laws. The ICI strongly believes that this issue merits the attention of the Court.

The I.C.I. is the national trade association of open-end investment companies ("mutual funds"), their advisers and underwriters. The mutual fund members of the I.C.I. have

about 7.5 million shareholders and assets of about $43 billion, representing over 90% of the assets of the domestic mutual fund industry. The I.C.I. is generally recognized as the spokesman for the mutual fund industry to the public and to the government.

The I.C.I. urges that this Court grant the petition for a writ of certiorari in respect of the determination by the Second Circuit Court of Appeals that the proxy statements of Chemical Fund, Inc. (the "Fund"), a Delaware corporation, for the years 1967-1971 violated the disclosure provisions of the federal securities laws by failing to disclose what the Court of Appeals determined to have been a reasonable business judgment of the independent board of directors to forego the possibility of return of the "excess" portion of portfolio brokerage commissions (referred to as "recapture"). This brief is addressed solely to this aspect of the Court of Appeals' decision.

SUMMARY

Under applicable law and for pertinent policy considerations, disclosure of the possibility of recapture and a decision of the independent directors to forego recapture is not, and should not be, required—particularly in the context of a decision characterized by the Court of Appeals as a reasonable business judgment (A-61).[1] This type of disclosure (i) has never been required by the Securities and Exchange Commission (the "SEC") and, indeed, was specifically considered and rejected by the SEC after being proposed for public comment as a possible disclosure guideline; (ii) generally is not reflected in proxy statements of mutual funds during the period in question and, thus, is

[1] References preceded by "A" are to the appendix to the Petition submitted by the Petitioners.

contrary to longstanding industry and administrative understanding and practice; (iii) is inconsistent with the reliance placed on the independent directors by the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq. (the "1940 Act"), thereby implicitly casting doubt upon the good faith judgment of the independent directors and their discretion in the management of corporate business and affairs; and (iv) will not provide information that is relevant to shareholders of a mutual fund.

The Court of Appeals' decision that a long-standing industry disclosure practice was, in retrospect, incorrect could have a widespread disruptive impact upon the mutual fund industry and, ultimately, upon other industries as well.

ARGUMENT

I.

Under applicable law and industry practice disclosure of the possibility of recapture and the decision of the independent directors to forego recapture is not, and should not be, required.

A. The SEC has not required disclosure of the possibility of recapture and the decision not to recapture and such disclosure has not been common practice in the mutual fund industry.

In general, the materiality of a disclosure depends on the facts and circumstances of the particular event. However, the type of disclosure about recapture which the Court of Appeals has suggested may be characterized as "generic" in nature, since it was a disclosure which would be common to many mutual funds. The factual variables in this context would seem limited.

Unlike the case with industrial or other companies, mutual funds are under continuing surveillance by the SEC as a result of its constant review of filed materials (proxy statements, current prospectuses and annual reports), inspections and investigations of practices and procedures, and its substantive regulation over their activities. The SEC has also been active in the development of specific disclosures for mutual funds, and the mutual fund industry has grown to rely upon the SEC practice of establishing disclosure guidelines, including those relating to the form and content of generic disclosures.[3] Thus, mutual fund disclosures have been both standardized and increased in a standardized manner through the process of accretion, primarily in response to SEC requirements, whether by the so-called "letter of comment" technique or by the adoption by the SEC of specific disclosure guidelines.[3] This, in large part, accounts for the fact that a number of the types of disclosures made by a particular mutual fund are routinely strikingly similar to the disclosures made by most other similar mutual funds.

During the period in question there was, and currently is, nothing in the SEC forms for proxy or registration statements or otherwise which expressly required, or would suggest, the need for the disclosure as to recapture which the Court of Appeals would require. The SEC had considered and subsequently rejected a disclosure guideline concerning

[3] Mutual funds continuously register their shares under the Securities Act of 1933, 15 U.S.A. §§ 77a et seq. (the "1933 Act"), and are the subject of legislation specifically enacted for their regulation, *i.e.* the 1940 Act.

[3] *E.g.*, SEC Guidelines for Investment Company Registration Statements, Release No. 40-7220 (1972). The disclosures suggested in the guidelines, to the best of our knowledge, have been generally adopted in the mutual fund industry with only minor variations.

the possibility of recapture. In 1969 the SEC published for comment proposed guidelines for the preparation of Forms S-4 and S-5,[4] which would have required mutual funds to disclose the facts that recapture was possible and that the directors had elected not to recapture.[5] After comments received in response to these proposed guidelines were considered by the SEC, it formally decided in 1972 not to require this disclosure. Disclosure relating to recapture was required by the SEC only in instances where a mutual fund did recapture.[6] Thus, the SEC necessarily determined that disclosure about the possibility of recapture, and the directors' rejection of this option, was not material for inclusion in documents prepared in accordance with the federal se-

[4] Forms S-4 and S-5 are the applicable registration statement forms under the 1933 Act for the underlying shares of closed-end investment companies and mutual funds, respectively.

[5] Release No. 40-5634. Two alternative forms of suggested disclosure proposed by the SEC in this release were as follows:

Alternative #1:

"The Company's board of directors and its adviser could agree to make arrangements to return to the Company the benefit of a portion of the brokerage commissions charged on portfolio transactions. No such arrangements have been made."

Alternative #2:

"The Company's board of directors and its adviser could agree to make an arrangement with ..... & Company to return to the Company benefits equal to the brokerage commissions ..... & Company receives on portfolio transactions from which the investment adviser benefits. No such arrangement has been made."

[6] Release No. 40-7220. The form of suggested disclosure adopted by the SEC in this release was as follows:

"The Company and ..... & Company have made an arrangement whereby .....% of the net profit from brokerage commissions earned on Company transactions placed with ..... & Company is returned to the Company by ..... (describe the mechanism through which the Company benefits, *e.g.* in a reduction in the advisory fee)."

curities laws.[7] In respect of the generic disclosure under analysis, the determination of the SEC as to the adequacy of the disclosure should be entitled to significant weight and deference. The SEC is the agency charged with the administration, interpretation and enforcement of the federal securities laws; the Staff of the SEC continuously reviews proxy statements, prospectuses and reports of all mutual funds; the SEC has expertise in, and has specifically examined, industry-wide practices dealing with recapture and brokerage allocation; and the SEC is aware of the mutual fund industry practice of reliance upon a general disclosure pattern.

To the extent we have been able to determine, it was not the practice for those mutual funds which had decided not to recapture[8] to disclose that the directors had considered and rejected recapture.[9] Thus, such a disclosure obligation, retroactively imposed, could expose a substantial part of the industry to claims of liability uncertain in nature and amount for past conduct which, at the time, was in accordance with the applicable laws as then interpreted.

[7] The SEC decision on this issue should apply with equal force to the disclosure requirements for proxy statements. The Court has narrowed its holding to the proxy statements of the Fund for procedural reasons (A-61).

[8] A decision to forego recapture during this period was, in our belief, not unique in that a number of other mutual funds had made similar decisions. This was due in part to the fact that the law was unclear as to the circumstances under which recapture was permitted or required due to the inherent conflict of interest (real or apparent) in permitting recapture. The possibility of a conflict of interest was one of the factors considered by the independent directors of the Fund (A-57).

[9] This conclusion is based upon our knowledge of the mutual fund industry and a review of proxy statements of various mutual funds for the period in question.

B. The interests of the shareholders of mutual funds are protected by the independent directors.

More so than has been typically the case with industrial or other types of corporations, the 1940 Act has always contemplated an active role for the independent directors of mutual funds as "watchdogs" for the interests of the shareholders.[10] In fact, Congress, recognizing that shareholders of mutual funds are disinclined to remove or change a mutual fund's adviser,[11] strengthened the role of the independent directors by enacting the Investment Company Amendments Act of 1970 (the "1970 Amendments"),[12] the provisions of which were applicable for a part of the period in question. The Court of Appeals' decision on recapture disclosure is inconsistent with the Congressional intent as to the purpose and the role of mutual fund independent directors.

The Court of Appeals found that the independent directors of the Fund were fully and adequately informed by management of the possibility of recapture and that the directors did not breach their fiduciary duties to Fund shareholders by electing not to recapture (A-61). Therefore, in terms of the impact of the Court of Appeals' decision on the mutual fund industry, the environment is one in which the independent directors have exercised a reasonable business judgment, and, in such an environment, the interests of the shareholders are adequately protected without disclosure of the alternatives considered by the independent directors.

[10] See, *e.g.*, Sections 10(a) (composition of board of directors), 15(c) (approval of advisory and underwriting contracts) and 32(a) (selection of independent accountants), 15 U.S.C. §§ 80a-10(a), 80a-15(c) and 80a-32(a).

[11] See S.Rep. No. 91-184, 91st Cong., 2nd Sess. (1970), as reprinted in 3 U.S. Cong. & Adm. News, 91st Cong., 2d Sess. at 4901 (1970).

[12] Pub.L. No. 91-547, 84 Stat. 1413 (1970).

The interests of the shareholders of the Fund were also protected by the fact that more than 50% of the directors of the Fund were independent for the entire period in question.[13] Moreover, while the concept of a "disinterested" director was not introduced until the enactment of the 1970 Amendments, the independent directors were in fact "disinterested" for the entire period in question (A-21).

To require disclosure of the possibility of recapture and the independent directors' decision to forego recapture in these circumstances suggests that the action of the independent directors was suspect, and that shareholders should be fully informed respecting all possible alternatives of a good faith, disinterested judgment of the independent directors on what could only be the premise that the decision may not have been made properly. A decision to forego recapture is similar to many other alternatives relating to advisory agreements which the independent directors from time to time may consider. If the possibility of recapture should be disclosed, why not disclose other alternatives which can have a direct monetary impact on mutual funds —or, perhaps, the individual votes of directors on different issues? The securities laws traditionally have not required disclosure of this type of evaluation of alternatives, cer-

[13] Section 10(a) of the 1940 Act (15 U.S.C. § 80a-10(a)) had, before the effectiveness of the 1970 Amendments, required that 40% of a mutual fund's directors be "unaffiliated" (as defined in Section 2(a)(3), 15 U.S.C. § 80a-2(a)(3)) and currently requires that 40% of such directors be "disinterested" (as defined in Section 2(a)(19), 15 U.S.C. § 80a-2(a)(19)). Moreover, Section 10(b) of the 1940 Act (15 U.S.C. § 80a-10(b)) provides, under certain circumstances, that a majority of the directors of a mutual fund may not be (a) regular brokers of the mutual fund or affiliated persons of such brokers, (b) the principal underwriter of the mutual fund or interested (affiliated before the effectiveness of the 1970 Amendments) persons of such principal underwriter or (c) investment bankers or affiliated persons of investment bankers, and Section 10(c) of the 1940 Act (15 U.S.C. § 80a-10(c)) prohibits a majority of the directors of a mutual fund from consisting of officers, directors and employers of any one bank.

tainly not in the context of deliberations by independent parties, such as the independent directors in question. Moreover, in requiring disclosure of the decision making process of directors, the Court of Appeals' decision may inhibit the free flow of ideas among directors, thereby undercutting their effectiveness in managing the business and affairs of corporations as required by federal and state law.[14]

C. The omission of a disclosure in proxy materials as to the possibility of recapture and the decision of the independent directors to forego recapture is not material.

The proxy provisions[15] of the federal securities laws have been adopted as a means to furnish shareholders with information as to which there is a substantial likelihood that a reasonable shareholder would consider important in deciding how to vote. See *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L. Ed.2d 757 (1976). Matters as to which shareholders' votes were solicited in the instant case were the election of directors and the approval of the investment advisory agreement (A-70), and, to be material under the standard established in *TSC Industries*, it is necessary to determine that the information in question would be important in a determination of the qualifications of the persons nominated for election as

[14] If the state corporation laws are viewed for guidance, there is typically a separation between the type of decisions that are made by the directors and those which require shareholder approval. A decision concerning an issue such as the possibility of recapture is usually left to the discretion of the directors, who are charged with the fiduciary duty of managing the business and affairs of the corporation.

[15] Section 20(a) of the 1940 Act, 15 U.S.C. § 80a-20(a), and Section 14(a) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78n(a), and the rules promulgated by the SEC thereunder.

directors[16] or would be important to an evaluation of whether to approve an investment advisory agreement submitted to the shareholders.

Their good faith business judgment whether or not to attempt to recapture does not, we respectfully submit, concern the qualifications of the directors. Indeed, the Court of Appeals found that the actions and decisions of the independent directors were reasonable business judgments properly considered and determined (A-61). This holding is inconsistent with any suggestion that the qualifications of the directors were in question. Moreover, the availability of information important to the qualifications of directors and required by Rule 20a of the 1940 Act, 17 Code Fed. Reg. § 270.20a, is not at issue in the instant case.

Matters of importance to shareholders in voting upon investment advisory agreements (disclosures of which are not at issue here) include the financial position of the adviser and information concerning the executive officers of the adviser. Proxy statements traditionally discuss the various types of compensation received by an adviser from the mutual fund, but do not disclose alternatives possibly available to mutual funds, which are not availed of because of the good faith business judgment of the directors. The shareholders of the Fund were not required to vote, and, to the best of our knowledge, shareholders of mutual funds typically do not vote, on the discreet question of whether to recapture.[17]

[16] Thus, the proxy rules promulgated by the SEC under the 1940 Act require information about the principal occupation of all directors and their relationships with the mutual fund. See Rules 20a-2(a)(5)-(9), (11) and 20a-3(b), 17 Code Fed. Reg. §§ 270.20a-2(a)(5)-(9), (11) and § 270.20a-3(b).

[17] Provisions for commission sharing arrangements may be included among the many provisions in a form of advisory agreement to be voted upon by the shareholders.

We submit that the possibility of recapture is no more important to a shareholder voting on an investment advisory agreement than other alternatives which may have been considered and rejected by the directors, such as the selection of one of a range of possible advisory fees,[18] the allocation of expenses between the mutual fund and its adviser, whether the advisory fee should be asset based or performance based, the amount of the sales load on sales of the mutual fund shares, the manner by which the shares of the mutual fund are distributed or discussions relating to specific investment techniques utilized by the adviser—none of which matters are or should be normally disclosed in the context of a vote on an investment advisory agreement.

II.

The Court of Appeals' decision will have a disruptive impact on the mutual fund industry.

The mutual fund industry has been literally inundated by litigation over the last 15 to 20 years. The first major wave of litigation involved the "reasonableness" of the advisory fee.[19] This was followed by litigation concerning

[18] Advisory fees, which are subject to negotiation between the adviser and the mutual fund, are subject to no minimum or fixed rate structure. Thus, the range of possible fees is limitless and the alternatives available to the directors in negotiating a fee are far ranging. Not only is the amount of the fee subject to negotiation, but the composition of the fee is also flexible, *e.g.*, which expenses of operations should be allocated to the mutual fund and which should be allocated to the adviser (subject to certain state law restrictions).

[19] See, *e.g.*, *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961) and *Saxe* v. *Brady*, 184 A.2d 602 (Del. Ct. of Chancery 1962).

the sale of control of mutual funds[20] and then by a further flood of litigation involving mutual fund brokerage practices.[21] In general, the litigation has subsided for a variety of reasons, including the fact that Congress has essentially dealt with each of the areas that was the subject of litigations. The question of the reasonableness of management fees was explicitly considered by the 1970 Amendments in Section 36(b) of the 1940 Act, 15 U.S.C. § 80a-36(b); the issue of the sale of control of mutual funds was focused upon in the Securities Acts Amendments of 1975[22] (the "1975 Amendments") by Section 15(f) of the 1940 Act, 15 U.S.C. § 80a-15(f); and the question of brokerage practices was addressed in the 1975 Amendments by Sections 6(e) and 11(a) of the 1934 Act, 15 U.S.C. §§ 78f(e) and 78k(a).

Due to the establishment of competitive rates of brokerage commissions,[23] and the adoption of Section 11(a) of the 1934 Act, 15 U.S.C. § 78k(a), by the 1975 Amendments (basically prohibiting the combining of brokerage with discretionary investment management after May 1, 1978), mutual funds are, as a practical matter, not at present faced with the decision of whether to avail themselves of the form of recapture at issue in the instant case.[24] However,

[20] See, *e.g.*, *SEC* v. *Insurance Securities, Inc.*, 254 F.2d 642 (9th Cir. 1958), cert. denied, 358 U.S. 823, 79 S.Ct. 38, 3 L.Ed.2d 64 (1958) and *Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971).

[21] See, *e.g.*, *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied sub. nom. *Johnson* v. *Moses*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971) and *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), cert. denied, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976).

[22] Pub. L. No. 94-29, 89 Stat. 97 (1975).

[23] See Rule 19b-3 promulgated by the SEC under the 1934 Act, 17 Code Fed. Reg. § 240.19b-3, which became effective as of May 1, 1975, and Section 6(e) of the 1934 Act, 15 U.S.C. § 78f(e).

[24] The SEC is currently considering proposed rules under Section 11(a) of the 1934 Act, 15 U.S.C. § 78k(a), which, if adopted, might permit mutual funds the opportunity to obtain a form of possible recapture. See SEC Release No. 34-13388 (1977).

as indicated, the Fund was not unique in not disclosing the directors' consideration and rejection of this form of possible recapture, and the Court of Appeals' decision could have a wide ranging disruptive impact upon the mutual fund industry, casting doubt about actions taken under proxy statements in prior years. A new round of litigation could be triggered, involving many of the same substantive matters that have already been addressed by Congress, but contending that inadequate disclosure has been made respecting these issues in the past.

The Court of Appeals' decision is also likely to precipitate additional litigation alleging non-disclosure of any number of other alternatives considered and rejected by directors where such disclosures had not been made by members of the mutual fund or other industries. Shareholders of mutual funds and other corporations will not be benefited by the proposed disclosures, and unknown and uncertain liabilities on a broad basis could be created by the Court of Appeals' decision.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari filed by the Petitioners to review the judgment of the United States Court of Appeals for the Second Circuit should be granted.

September 16, 1977

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